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THESIS

MANAGEMENT INVESTMENT TRUSTS

by

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CHAPTER I

THE PROBLEM AND DEFINITIONS OF TERMS USED

In the short space of sixteen years investment trusts have become a major industry, investing and handling over a billion investment dollars. In view of this very rapid growth, it seems plausible that some attention should be given to the subject of investment trusts. It will not be the purpose of this thesis to cover all phases of investment trusts, but rather to limit the study to one type; namely, management trusts, and to further limit the study to those aspects of management trusts that are of importance to the investor. In other words, this study, when completed, will attempt to show the potential investor the advantages of investment trust securities, but pointing out along the way the weaknesses to be found in the trusts, and the items the investor should note in an intelligent analysis of the trusts.

The question of management will be considered from the standpoint of efficiency in the handling of investors' funds; compensation, which is a very important phase of management trusts, and the methods of appraising various types of management within this field of finance.

Definitions of Terms Used:

Investment Company. Throughout this thesis an investment company will be a trust or issuer which

(1) holds itself out as being engaged primarily in the business of investing, reinvesting, or trading in securities; and

(2) is engaged in the business of investing, reinvesting, owning, holding, or trading in securities having a value exceeding forty per cent of the value of each issuer's total assets.[1]

Since the purpose of this study is not to conduct a research into all classes of investment trusts, of which there are four main types - including (1) open-end company, a management company which is offering for sale, or has outstanding, any redeemable security of which it is the issuer; (2) closed-end company, which is any management company other than an open-end company - but rather to limit the study to management companies, a clear definition is necessary.[2]

The Federal Government, which has recently passed the Investment Company Act of 1940, clearly defines the management concept of investment trusts.

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[1] Investment Companies - Public, No. 768, 76th Congress, H.R., 10065, p. 10

[2] Ibid., p. 12

> Management investment companies; in which management has complete discretion as to the investments to be made. These companies are subdivided into open-end companies -- those in which the security holders can, at their option, compel the company to redeem or repurchase their securities at the actual asset value of such securities; and closed-end companies -- those which do not accord this privilege to the stockholders.[3]

To better understand the American investment trust a short history of the beginning of this type of financial institution will be helpful.

The origin of the investment trust can be traced to the formation of the Societe de Belgique in the first quarter of the nineteenth century. This institution was founded by the royal family of Holland before the separation of Belgium and Holland. After the separation of these two countries the stock of the company fell into private hands and during the course of time the company acquired a wide latitude of holdings in private corporations. Since this institution purchased these securities, not only for investment but also for control, it was not a pure investing trust. The investment trust made considerable progress in Switzerland, but had little success in France, Germany, or the rest of the continent. "Its greatest development occurred in England, where in that

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[3] Ibid., p. 6

quarter of the last century a number of these institutions were formed."[4]

> The early British investment trusts followed highly speculative policies and suffered heavy losses in the panic of 1890, which seriously depressed securities on the various exchanges of the world.[5]

However, these trusts, profiting by these unfortunate experiences, and as a result, until World War I, followed very conservative policies by investing in high-grade securities and accumulating vast surpluses for future losses. The capitalization of English trusts generally consists of preferred stock which comes with its prior claim on dividends, usually fixed at a certain percentage. The second class of stock is ordinary, or common stock which generally receives additional earnings on the trust after preferred dividends have been paid. The former issue, as in any company, has a limited yield but is a safer investment as the dividends are guaranteed. The common stock offers the possibility of a higher yield with increased risks. In 1933 the total capital of the British investment trusts was estimated at a billion dollars.[6]

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[4] Moulton, H. G., Financial Organization and the Economic System (New York, 1938), p. 176

[5] Ibid., p. 178

[6] Ibid., p. 176

From the British trusts America, in the post-war years, copied the trust idea. American development had started before this but the era of real growth followed the war.

The evolution of the investment trust in the United States has passed through three stages; namely, the period of growth, when the emphasis was on foreign issues. At this time there were only seventeen registered companies, and the total estimated assets amounted to less than fifteen million dollars. The second stage, from 1925 to 1929, was a period of very rapid expansion during which the estimated market value of the assets rose to a maximum of about six billion dollars.[7] At this point operations were more or less confined to American securities. The third stage, covering the years from 1930 to 1935, was known as the consolidation period. As a result of shrinkage in the security values, the assets dropped to 1.5 billion dollars in 1932, subsequently rising to approximately 2.4 billion dollars as of December 31, 1935.[8] At the close of 1936 the companies in this field totaled 1077.[9]

The enormous expansion in the investment trust field in the years 1925 to 1929 was simply a part of a general development in the field of finance resulting from

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[7] *Loc. cit.*
[8] *Ibid.*, p. 177
[9] *Ibid.*, p. 181

a surplus of money and the spirit of the times. Other factors included the extension of foreign loans and mass speculation in the securities market.

At this period many financial institutions attempted to start investment trusts and consequently mismanagement was widespread. In the ensuing depression losses to investors in many investment trusts were staggering. In a vast number of cases the stockholders' entire equity was wiped out. By 1932 the shares of some well-managed trusts were selling for one-half the face value, while their holdings could be sold in the market for proportionately more. However, the reorganization of the following years along lines suggested by successful trusts have again placed this institution in a position to render a very useful service to the investing public.

The self-organization of many trusts has recently been followed by the passage of the Federal Government's Investment Company Act of 1940. This bill has done much to clarify the situation. The makers of the act felt that the industry had, on the whole, voluntarily done away with malpractices and mismanagement. However, it was apparent that complete divorce of these evils from the industry could not be realized without the enactment of a Federal law. This conclusion was conceded by virtually every witness who appeared before the sub-committee, and was the

opinion of a great number of persons within the industry.

The Securities Act of 1933 and the Securities and Exchange Act of 1934 have not acted as deterrents to the continuous occurrence of abuses in the organization and management of investment companies.

In view of the history concerning the rise of investment trusts many will ask, "Why investment trusts?" The answer may be given in one word - security. This security, which is of the utmost importance to the small investor, may be found in those companies which give to the investor, for a relatively small amount of money, the diversification of securities which means a secure investment of his money in the light of vast industrial holdings.

Since the World War small investors have had opened to them new and heretofore unattainable fields for investment of minimum amounts of money. It started a new age of finance, giving to "one-share" investors the right to place their money in companies which in the past were financed by the powerful few.

Robinson says: "The person of modest means came into his own during the nationwide Liberty Loan drives, and the salutory habit of clipping coupons has continued with our people."[10]

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[10] Robinson, L. R., Investment Trusts, Organization and Management (New York: Ronald Press, 1929), p. 12

In the pre-war and pre-depression days the average investor felt secure if his excess funds were placed in "Governments" or so-called "gilt-edge" securities. More than one investment expert advised his listeners to place their funds in railway stocks and bonds. Today many see the folly of this policy. The average railroad stocks and bonds are far below the par value or even the price at which they were purchased in the past. Stocks and bonds of rails are large speculative issues.

Where does the "one-share" investor stand on this scheme of things? He can ill afford counsel for investments where the fee would wipe out any profit. Consequently, many small investors are turning to sound investment trusts for the safety that comes from diversification, investment counsel and good management. The investor receives all this by holding investment trust issues.

All this material answers the question - "Why investment trusts?"

The body of this thesis will then assume that the question has been answered, and with the answering of the interrogation comes the next inquiry - "How may an investor determine the type of trust best fitted to his needs - what shall the investor look for?"

The author of this thesis feels that management investment trusts offer to the investor the safest type of investment trust.

If the research is successful, at its completion the potential investor will have before him a study that will serve as a guide to investing in these trusts. The most important phases of this industry will be covered.

In the appendix the author will present for study typical companies in this industry. They will be presented from the following standpoints: date of incorporation, classification of portfolios, types of securities issued, officials of the company, securities that the trust must purchase, according to the agreements signed by the trust.

In any study of these trusts attention should be called to a kindred agency which has developed in recent years, the investment counsel. As the name implies, its primary purpose is to advise either individuals, groups of individuals, or companies on investment procedure.

> The service is intended to be of a twofold character: to select a sound and well-balanced list of securities adapted to the needs and circumstances of each client; and, second, to shift their security holdings, from time to time, from bonds to stocks, and vice versa, with a view to taking advantage of major market trends. Their greatest service has been in restricting the portfolios of their clients to representative and marketable securities.[11]

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[11] Moulton, H. G., Financial Organization and the Economic System (New York, 1938), pp. 181, 182

As has already been cited, the average investor has neither the securities nor the money to seek advice from investment counsellors. But the investment trust has both the holdings and finances to use for this type of aid. Today, most every trust has either at its disposal or in the organization itself staffs of market technicians whose sole duty is to advise action to be taken on the movements of the major exchanges.

CHAPTER II

MANAGEMENT

The fundamental reason for the existence of management investment companies, or investment trust funds, is stated in Glascow's book as follows: "The basic principle of the trust company method; that is, of the good trust company, expressed in another way, is the prior assumption that there is no such thing as security in finance."[1] This is rather a startling statement, but true. The management investment trust, by virtue of authorization of power to the management and the use of diversification, attempts to solve and remove this insecurity.

The lack of security and the ever-changing nature of the financial and economic worlds has been proved many times. The study by Standard Statistics[2] of six portfolios of common stocks set up respectively on December 31, 1900, 1905, 1910, 1915, 1920, 1925, and carried forward to the end of 1929, indicated some rather startling changes. One share of the common stock of each of the twenty companies was included every time. Altogether fifty-three stocks were included in the several portfolios,

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[1] Glascow, The English Investment Trust Companies (London: Eyre Spolleswade, Ltd., 1930), p. 7

[2] Standard Statistics, August 1930

and twenty-one of the fifty-three had to be eliminated due to the passing of dividends or to other causes. Each elimination resulted in a depreciation of the original capital investment.

The fact that securities are continually changing in investment merit has been cited many times. In an article entitled "Blue Chips, Unless Recounted Often Tend to Turn Pink,"[3] a statement was made that at the end of 1919 a group of sixteen stocks, with uninterrupted dividend records up to thirty-six years, could be purchased at the end of 1929. The value of the sixteen investments at this date (1929) had decreased from 1.6 per cent to 89.6 per cent of the original investment with an average of twenty-five per cent. The uninterrupted dividend received at the end of 1919 averaged fifteen years. What all this illustrates is the necessity for intelligent supervision of investments through the years rather than the patience on the part of the investor to determine high-grade stocks through a history of dividend record of any particular security or group of securities.

Illustrations such as this could be cited indefinitely. Investors know from experience that with the possible exception (in normal times) of high-grade governments, municipals, railroads, industrial and utility

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[3] New York Saturday Evening Post, July 26, 1930

bonds, changes are necessary from time to time in any investment list. This is probably the most important service of the management investment company, as the managers are given the opportunity to supervise and change the portfolio to meet changing conditions.

Management investment companies of many types have operated in the United States for several decades, although prior to 1923 only a few such companies existed and they were generally limited in clientele. With the long "bull" market in stocks, and the prosperity from 1924 to 1929 the number of these trusts multiplied rapidly.

Investment trusts, partially, but holding companies, finance companies and trading companies, to a greater extent, were the last development in the 1928-29 stock-market frenzy. As a result the common stock of these companies soared to unwarranted heights and in 1929 were selling, on the average, at about fifty per cent in excess of the actual underlying liquidating values per share. This excess of liquidating value was premium.

With reference to management trusts alone, the stocks; that is, majority of them, declined from this mentioned premium to substantial discounts below liquidating values, and remained at discounts throughout 1930 and 1931.

Keans's Manual[4] makes known the fact that at the

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[4] Keane, Investment Trust Monthly (March, 1931), p. 125

end of 1929 a group of seventy-nine management investment stocks were selling, on the average, at 90.4 per cent of their liquidating values. At the end of 1930 this same group of stocks of the seventy-nine investment companies were selling at 83.3 per cent of their net asset value. On June 30, 1931[5] the stocks of forty-six investment trusts were selling on the average at 72.1 per cent of their net asset value. The lower percentage of June, 1931, was due partly to the inclusion of eleven preferred stocks, several of which were selling at a very low ratio to their net asset values.

As to the operating results of management investment trusts for 1929, 1930, 1931, figures could be gathered indicating that the aggregate declines of total assets of such organizations were considerably less than the declines of the stock market during these years. This is only natural for a portion of the assets were in cash, bonds and preferred stocks and management, as a whole, anticipated the decline during this period and built up liquid assets as a result. Whereas the average performance was better than the decline of the market for the same period, the performance of some managers was not as satisfactory; while the performance of other managers was better and, in some cases, considerably better than this

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[5] *Ibid.* (August, 1931), p. 389

average. Individual analyses of investment trusts become a factor of importance and should be the conclusion drawn from the foregoing material.[6]

In reviewing the rise of investment trusts one factor, as has been pointed out, is all-important; namely, management. With this in mind a discussion of management will be presented on the following pages.

The fundamentals of investment trusts are constant. Regardless of the type of trust the same principles must be pursued if the trust is to have a successful management and financial history.[7] The fundamentals of sound management are: protection of debentures and preferreds, not only from an asset but also from an income standpoint; the maintenance of a portion of the fund in cash at all times, the use of bank loans as only temporary methods of financing, and on relatively small amounts, an adequate distribution of risks at all times, a continual attempt to anticipate unfavorable economic and financial developments and the continual building up and adding to reserves and earned surplus.

To maintain these principles of safety American management trusts have copied the practices of foreign investment trusts. Williams and Marshall state:

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[6] Standard Statistics, March 30, 1931, p. 15

[7] Durst, W.N., Analysis and Handbook of Investment Trusts (New York: Rand, McNally and Company, 1932), p. 39

> American trusts are, to a certain extent, showing tendencies to follow a practice which is almost universal abroad -- the management of the trust and its financing are performed by another amalgamation which might be called the management company or fiscal agent.[8]

A further idea in the investment trust field in America is stated by the same authors:

> Management of the trust and its financing are performed by another organization which might be called the management. Also a group of trusts grouped together under control of one management. This has a tendency to reduce the financing costs of each trust in the group as well as the management cost.[9]

Management investment trusts should be considered in the light of the following comment by Professor A. S. Dewing:

> There must be foresight, guidance or control in every business enterprise; someone must buy raw materials and pay labor its daily or weekly wage, whether the goods manufactured sell for more or less than the expenditures involved in their costs. The business manager is no less significant than the laborer and his wages, the capitalist and his interest, and the business must yield a sufficient profit to reward this manager for his planning and the risks he is taking in paying his various contractual obligations.[10]

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8. Williams and Marshall, Investment Trusts in America (New York: The MacMillan Company, 1928), p. 22
9. Ibid., p. 23
10. Dewing, A. S., Financial Policies of Corporations (New York: Ronald Press), pp. 1182-1186

This last quoted paragraph suggests the question of the amount of management participation in the financing of a management investment trust. The usual assumption is that the managers and their associates will furnish a portion of the original capital. Managers, for their participation in financing, usually obtain securities junior to those held by the public. And, consequently, several years of successful operation are necessary to increase the value of the junior holdings, while the public holdings receive a dividend from the time of formation, or shortly thereafter, and have senior claims on assets and earnings.

For management's successful operation of the trust some compensation must be made. To compensate management five general plans are now in use. These plans tie together the interested public and the management.

The five methods of compensation are:[11] (1) by class A and B stock; (2) by a bonus of common stock to organizers and their associates and the public; (3) by options for the future purchase of the trust common stock at a price above, below, or at the issue price given to the organizers; (4) by an earning or contract basis; (5) by an arrangement under which the organizers and the

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[11] Durst, W.N., *op cit*., pp. 60-67

public are to remain on practically an equal basis through the increased value of common stock purchased under the same general plan.

To the potential investment trust investor these plans should prove of importance for upon these plans are determined the earnings of the public and the management as well as the control each group has in the company.

Class A and Class B stocks are the securities in the plan whereby Class A is superior to B, both as to dividends and asset payments. Class A is sold to the public and B is retained by the organizers and managers. This plan requires that satisfactory results are to be shown over a period of time before dividend payments on B stock is possible, and an increased asset value on the same class. Class A and B arrangement is a partnership, the public supplying the senior capital and the organizers and management supplying the junior capital. In some cases Class B stock has the sole, or majority, voting power; hence, making it, in many cases, as valuable or more valuable than Class A stocks.

Important considerations from the standpoint of the investor are: the relationship of the amount paid by the public for the Class A stock as to the amount paid for the Class B; the ratio and the extent of priority as to earnings and dividends of the Class A in comparison with Class B.

The second plan is one in which the original stock, both to the organizers and to the public, is virtually a bonus. This plan requires that several years of satisfactory and better than average results are necessary to create and build up equity for the common stock.

In most cases the management and organizers furnish a major portion of the capital and have the advantage of the use of the entire capital with which they are able to show their ability to successfully handle and invest this money. On the other hand, the public have purchased preferred stocks or so-called senior securities, receive interest and dividends from their holdings and, as a result of successful operation, the common stock may increase in value.

In the meantime, the preferreds, which are usually sold at par, may decline. This is due to many causes, the more important being changes in the money market, causing lower prices for fixed interest and dividend obligations. The investor should closely check the investment policies of trusts using common stocks as bonuses. Unless the policy is conservative and can show unusual appreciation in the security market considerable time will elapse before a substantial equity is built up for the common stock bonus.

The third plan of cooperation between the public and management is the granting to management the right or option for the future purchase of stock at stated prices. In some cases the public is granted warrants similar to those allowed the managers. If such rights are conferred above the issue price, several years of constructive investment management will be necessary to make the exercise of these rights profitable. If the options or warrants are extended below issue price, the later exercise of these rights may tend to reduce the equity of each share outstanding.

> Compensation to managers for their services may be provided by allocating to managers a portion of investment trust earnings through the ownership of shares or option on the trust issues.[12]

If this right is exercised above the issue price, the plan is similar to the Class B arrangement and the stock will have to become more valuable to make the warrants useful. But if the warrants are exercised below the issue price they will tend to pull down the value of the stock.

Under the terms of the fourth plan, which is an earnings or contract basis, the management and/or the organizers derive a certain percentage of the profits

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12. Fowler, J. F., American Investment Trusts (New York: Harper Bros., 1928), pp. 147, 148

of the corporation since the beginning of the operation. Under this plan the management receives no compensation unless the corporation earns annually a certain percentage on the capital and surplus as of the beginning of the year. Such earning requirements are cummulative so that in any one year the company fails to earn a profit of the specified amount, the difference may be made up in subsequent earning periods; that is, before the management is allowed any compensation.

Another plan under this general heading is one in which a small percentage of the average resources, usually at market value, is paid to the managers. These percentages are usually 1/8 of 1 per cent quarterly, or ½ of 1 per cent annually, and cover all statistical, research and investment managerial services.[13]

> Managers' compensation may be derived from charges for raising capital and from a redemption fee, if any. It may take the form of a management fee which is paid out of the income. The standard management fee is ½ of 1 per cent of invested capital.[14]

Management fees of four typical open-end trusts are cited below:[15]

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[13] Durst, W.N., _op. cit_., p. 66
[14] Fowler, J.F., _op_. _cit_., p. 147
[15] _Ibid_., p. 148

	% of Invested Capital	% on Income
Incorporated Investors	½	
*Investing Corporation of America		15
Investors Management Company	½	
Massachusetts Investors Trust		6

*Fee is after deduction of 5% annually on amounts paid in.

This fourth plan has an advantage from the viewpoint of the investor, since the managers are usually paid on the basis of average market value of assets and will naturally endeavor to report market values of assets as high as possible in order to receive larger income for managerial services.

The fifth plan is that of the sale of common stock of the investment trust to the public at the same price as to the organizers, and without any other methods of compensation attached thereto.

This is sometimes accomplished through the sale of units of preferred and common stock. The organizers furnish a smaller share of the original capital than the public, but are to receive a generous portion of future earnings through substantial stock holdings.

Fowler states: "Compensation to managers for their services may be provided by allocating to managers

a portion ... earnings through their ownership of ... option or shares."[16]

Variations are possible on all these plans. One such variation is worked out from the fifth plan; namely, that of selling the stock to the public and organizers at the same price. The organizers may retain voting power through the creation of voting stock as compared with public non-voting stock. Other plans have placed the organizers and the holding public on equal footing as to future participation in earnings.

There are many minor details that should be of importance to the investor; organization expenses may be borne outright by the organizers and the operating expenses carried by the managers; the directors and officers may serve a certain length of time without salaries. Outweighing these generous considerations is the fact that the organizers have the use of the capital, in many instances without restriction, but definite managerial results are more important.

To further consider the principles of management investment trusts; once the potential investor has determined his relationship in regard to his holdings, it is of importance to consider the actual managers from

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[16] Ibid., p. 147

the point of view of honesty, experience, knowledge of finance and securities.

Enough has been written to indicate the importance of management in trusts as in any other business enterprise. Therefore, we may conclude that management is the most important aspect of this industry that the potential investor must study before his funds are placed in one trust or another. Ability may often be determined by past experience, and training may be readily ascertained. Perhaps the most important angle from which to view management is stated by Williams: "Would I choose these men for the trustees of my affairs?"[17] It is then important to ascertain if these men are in any way connected with other interests in such capacities as to prejudice them in a free selection of securities for the trust. If such is the case the investor would do better to pass by this trust. For an outside interest would, in many cases, do away with the proper diversification necessary to the proper functioning of a successful trust. This would only happen in trusts where the managers were not answerable for the securities held. The danger becomes obvious when one considers that cupidity might cause the officers to change the trust's holdings for an outside

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[17] Williams and Marshall, op. cit., p. 76

consideration. In such an event the assets of the trust might decline to such an extent that the investors' equity might be totally lost.

> ... dishonesty can ruin an investment trust as well as any other institution, which brings about a reiteration of the necessity of carefully examining the records of the officers and directors.
>
> Managerial ability can express itself just as logically as in the operation of an industrial enterprise, and the investment trust is in business to build up reserves and dividends for stockholders through alert seizures of investment possibilities.[18]

An investor will do well to note the names of men in any way connected with the trust. These statements, along with other aspects of the company, are on file with many government and private agencies, among them being the New York Stock Exchange, Poor's, Moody's, or any other book publishing listings of companies.

Too much emphasis cannot be placed upon the type and character of the men who control the policies of an investment trust as well as any other type of business.

This chapter has dealt with:

(1) the reason for the existence of management investment trusts;

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[18] Ibid., p. 77

(2) the changing character of securities that call for a clear understanding of markets and securities backed by the ability to so handle these securities as to make a profit for the holders;

(3) the fact that, though the net assets of management investment trusts declined during 1929, 30, 31, the decline was not as great as the decline of the stock market during these same years.

(4) the methods of management compensation, and the

(5) further principles of management in regard to ability, experience, and honesty.

As has been previously cited, management is the most important phase of business, be it the investment trusts, industrial enterprises, or any other business activity. In view of this statement emphasis has been placed upon principles of management in the management investment trust field.[19]

The following chapter will be a study of load charges, expenses and incidental costs of the investment trust field.

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[19] Ibid., p. 77

CHAPTER III

EARNINGS AND EXPENSES OF THE TRUST

Earnings and expenses of the trust and of the investor, although of importance, are comparatively minor factors in analyzing investment trusts. However, the more important factors and considerations regarding management trusts are the earnings and other achievements obtained by the management.[1]

> The annual operating expenses of the English and Scottish investment trusts amount to about 4/10 to 5/10 of 1 per cent of the total capital. Such low expense ratios are usually possible only after several years' operations. In a survey of management investment trusts for 1929[2] operating expenses of sixty generally diversified investment trusts amounted to 6/10 of 1 per cent of the total invested capital; twenty-six finance, trading, and holding companies reported operating expenses of 4.10 of 1 per cent. The general average of 105 companies was 5/10 of 1 per cent.

"In a survey of the ratio of expenses to assets for 1930,[3] the average expense ratio of forty-four management investment trusts and related companies was 0.87 per cent. The ratios varied from 0.16 per cent to 2.29

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[1] Durst, W. N., (9), *op. cit.*, p. 81

[2] *Ibid.*, (14), p. 82

[3] *Standard Statistics, Trade and Securities Service, Mar. 30, 1931*

per cent." The average expense ratio for 1931 may have been slightly higher[4] as expenses possibly were not reduced as rapidly as the depreciation of total net assets, although some companies reported reduction of assets.

To further study the expenses of management trusts the investor should carefully investigate the load charges or loading charges, of the management trusts. This charge is simply a "top" or burden of organization placed upon the investor upon the purchase of the securities to pay for the cost of distribution; i.e., to cover the distribution companies' cost and the profit of the salesmen.

"Loading charge may be characterized as the known premium which the investor must pay to participate in the investment company."[5] Loading charges may be justified upon the same grounds as of the wholesalers' profit in commodity distribution. Without the middleman, who must make a profit to remain in business, prices would rise to the consumer as producers were forced to assume the entire burden of distribution.

Further justification arises when one considers that during the earlier periods of an investment trust's

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[4] Ibid., Mar. 11, 1932

[5] U. S. Government, Investment Trust and Investment Securities and Exchange Commission, 1939

life the securities are very often difficult to sell in competition with well-known shares.

To repeat the analogy of the wholesale distributor; on a product being introduced to a market, the wholesaler very often demands a higher commission in view of the cost involved in carrying (in his stock) a product which, as yet, lacks a secure following.

The question of loading charges is important only when the investor wants to determine the amount of his money that will go to work for him in the investment trust. It is not usually possible for him to learn just what is the cost to the trust in the sale of its capital or obligations.

The Federal Government, in a report of the Securities and Exchange Commission made during 1939,[6] rather critically reviews the management trusts, both the open-end and the closed-end types.

In reviewing the open-end concept in relation to the cost to the investor and the distributor, the report states:

> The shares of forty open-end investment companies outstanding as of December 31, 1936, represents an original investment of about $422,000,000. Since a total of

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[6] Investment Trusts and Investment Companies

> $564,000,000 was paid into these companies during the period, it might be supposed that the $142,000,000 or 25% of the total paid in by investors, returned to shareholders through repurchases represented by the extent of the turnover of investors in this type of investment company. However, the factors must be considered which tend to alter this turnover ratio considerably.[7]
>
> The principal distribution of each of the larger open-end investment companies ... purchased shares from dealers and the public and resold these shares immediately, without the investment companies' being involved in the transactions. Data upon the volume of such trading are available for several of the larger companies and it is estimated therefrom that about $50,000,000 of open-end company shares were so purchased and resold. In addition, there is the whole field of trading in shares of open-end companies by dealers and others. Although no definite data are available, it is known that there are active over-the-counter markets for these shares and that was considerable activity by dealers in switching customers from one open-end company to another.[8]

Based upon the foregoing estimates it appears that for each dollar invested in open-end investment companies as of the end of 1938, it was necessary to market almost three dollars' worth of shares.

Closed-end companies differ from the open-end type in that closed-end trusts usually make single or

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[7] Glascow, *The English Investment Trust Companies* (London: Eyre Spolleswade, Ltd., 1930), p. 10

[8] *Ibid.*, p. 13

isolated offerings of their shares and changes in ownership thereafter require only the payment of brokerage commissions. A similar turnover in the shares of open-end investment companies, however, involves a repurchase and resale, either through the investment companies or intermediate markets of the dealers or distribution, and the cost to the new shareholder includes the addition of another selling commission or load charge.[9]

The justification that exists for the relatively high selling commissions of open-end securities during the earlier stages of development, due to the difficulty of marketing unknown shares, is followed, to some degree, by the three largest open-end investment companies[10] (Massachusetts Investors Trust, Incorporated Investors, and State Street Investment Corporation). These three companies have had loading charges during periods of active distribution generally lower than other open-end investment companies maintaining active selling organizations.

Merrill Griswold, chairman and trustee of Massachusetts Investors Trust, testified in regard to

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[9] In addition, there was sometimes charged a redemption fee which increased the cost to the public of maintaining individual funds.

[10] Williams and Marshall, Investment Trusts in America (New York: The MacMillan Company, 1928)

this company's increased loading charge in 1930 from 6% to 7% of the offering price; on February 1, 1932, it again increased the load to 8¼ of the offering price, and on May 20, 1933, it maintained the load of 8% of the offering price.[11]

> Q. What was the reason for the increase in the load to 1930 and 1932?
>
> A. The reason was that in those days the stock naturally did not sell as high as it does now, and the dealer had to sell more shares to make the commission that he does now ... We had to meet competition. Most of the trusts in the country charged about 8% or more ... If we at that time had reduced our load to 5¾% I don't think anybody would have sold our shares. They could get a better load from some one else.
>
> Q. The total load, or selling cost, of selling these shares to the public which was deductible from that figure (operating costs) was $5,900,000. Is that correct?
>
> A. Yes.
>
> Q. And the total operating expenses, including taxes over the same period were $1,500,000? That is approximately correct?
>
> A. I assume that is correct.
>
> Q. So that it cost about four and one-half times to get into this as you felt it necessary to manage it?

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[11] Op. Cit., 22

> A. It costs anywhere from 8 to 6 per cent to get into this trust, and our operating expenses averaged between 10 and 14 per cent per annum. They are now running at the rate of 10 per cent.

The material in the foregoing pages will serve to show the investor just what the cost is to him upon placing his money in an open-end investment trust. This thesis has touched upon loading charges as an item for the investor to study. Now a study of these charges seems apropos, having disclosed in the preceding pages the cost to the investor of distribution of open-end shares.

> The main source of compensation received by the distributors and dealers from the sale of shares of open-end investment companies is the published sales commission or loading charge. This charge is usually expressed as a fixed percentage of the net asset value per share and represents the disclosed premium over the basic price which the investor pays to become a stockholder or participant in the open-end company.[12]

This load is designed to cover all the distribution costs of the principal distributor and dealer. Similarly redemption fees charges upon redemption of shares are used by some open-end companies to cover the costs of repurchasing shares.

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[12] Durst, W. N., op. cit., p. 40

Although the portions of the published "loading charges" retained by the dealers and distributors do not seem higher than commissions received by distributors of other types of securities, the open-end distributor system permits the inclusion of certain multiple and hidden profits which do not prevail in the closed-end companies.

"The starting point in the determination of the distribution of profits from open-end investment company shares is the per share liquidating or net asset value."[13]

The theory behind this is that each new share will be sold by the company for an amount equal to the liquidating value of each outstanding share, and that each share at redemption will entitle the holder to a pro-rata part of the total assets.

All open-end companies are similar in that any calculation of offering and redemption prices starts with the net asset value per share, which in turn is based upon the market value of an estimated value of the portfolio holdings of the company. The method of computing the asset value is usually set forth in the charter or trust indenture.

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[13] *Ibid.*, p. 18

The Federal Government, during the course of its investigation,[14] compiled a table of "Methods of Calculating Liquidating Value for Purpose of Sale by 38 Open-end Management Companies."

		Number of Companies	
I	Valuation of Portfolio Securities		
	Prices of securities traded on an exchange are based on:		
	Last sale price	36	
	Closing bid price	2	38
	Prices of securities not traded on exchange are based on:		
	Closing bid price	28	
	Average of closing bid price and asked price	10	38
	Valuation made on prices as of:		
	Day of sale of trust securities	7	
	Previous day	23	
	Other	8	38
	Prices are adjusted:		
	To nearest dollar	3	
	Yes (not specified)	1	
	No	34	38
II	To Value of Funds as computed are added:	Yes	No
	Full lot brokerage	3	34
	Odd lot brokerage	0	38
	Odd lot premiums	1	37
	Administrative fees	0	38
	Fees of custodians or trustees	0	38
	Other items	7	31

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[14] Fowler (figures as of Dec. 1935)

III	From Total Assets are deducted book liabilities and:	Yes	No
	Estimated taxes on unrealized appreciation	24	14
	Other charges	5	33

IV	The resulting per share figure is adjusted to:	
	Nearest cent	24
	Next highest cent	8
	Nearest five cents	1
	Nearest eighth	1
	Nearest quarter	1
	Not adjusted	3

The asset value mentioned is the amount received by the investment company from sales of its own shares paid out by the company upon redemption in liquidation of its shares. The fees and loading charges superimposed upon the asset value usually go to the chief distributor.

"An interesting factor in the determination of the basic price of the shares is the return of capital received by new stockholders as dividends."[15]

It has been the practice of many open-end companies to calculate the selling price of each new share so that it will include a sum equal to the per share

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[15] U. S. Government Report, *op. cit.*, p. 21

amount set aside by the company for the payment of the next dividend or the shares already outstanding. This amount received by the company is distributed on the next dividend date. This method simply protects the old stockholder. It is not always brought to the attention of the new stockholder that he is receiving a return of capital in the form of dividends.

The next item of expense that should be noted by the investor is the published load. This charge has been stated in a number of ways: as a percentage of the asset value, as a percentage of the offering price of the share, or as a specified dollar amount.

To cite simple illustrations of this published load which may be more understandable than a statement of procedure:

Percentage of asset value -- Assuming each share of stock has a net asset value of $100, and the percentage is 5%, the investor would be bound to pay the published load of $6 for each $100 worth of stock purchased.

Percentage of offering price -- If the stock is offered at $100 while the asset value is $90, the percentage here would be $6 on the $100 offer and not on the asset value of the issue.

T A B L E II

LOADING CHARGES ON OPEN-END INVESTMENT COMPANY SHARES AT YEAR-ENDS 1927-1935 a/

(Stated as percentages of net asset values)

Name of Investment Company	1927	1928	1929	1930	1931	1932	1933	1934	1935
A. Three Largest Companies									
Incorporated Investors	6.0	5.0	5.0	5.8	6.95	6.95	7.5	7.5	7.5
Massachusetts Investors Trust	6.0	6.4	6.4	7.5	7.5	9.0	8.7	8.7	8.7
State Street Investment Corp.	--	--	--	--	--	6.4	6.4	6.4	b/ 6.4
B. Group Sponsored by Investment Counsel									
Eaton & Howard Mg. Fund "A-1"	--	--	--	--	--	3.0	5.0	5.0	6.4
Eaton & Howard Mg. Fund "B"	--	--	2.0	2.0	3.0	3.0	5.0	5.0	6.4
Eaton & Howard Mg. Fund "F"	--	--	--	--	--	3.0	5.0	5.0	6.4
First Investment Counsel Corp.	--	--	c/1.0	c/1.0	c/1.0	c/1.0	c/1.0	c/1.0	c/1.0
Investment Trust Fund "A"	1.0	1.0	1.0	1.0	--	--	--	--	b/1.0
Investment Trust Fund "B"	1.0	1.0	1.0	1.0	1.0	1.0	--	--	b/1.0
Investors Fund "C" Inc.	--	--	--	--	1.0	1.0	1.0	1.0	1.0
Loomis Sayles Second Fund, Inc.	--	--	--	--	--	--	--	0	0
R. B. C. Fund, Inc.	--	--	0	0	0	0	0	0	0
Third Investment Counsel Corp.	--	--	c/1.0	c/1.0	c/1.0	c/1.0	c/1.0	c/1.0	c/1.0
C. Others									
Administered Fund Second, Inc.	--	--	--	--	--	--	--	6.4	6.4
Affiliated Fund, Inc.	--	--	--	--	--	--	--	9.3	9.3
American Business Shares	--	--	--	--	--	9.5	9.5	9.5	9.5
American General Equities, Inc.	--	--	--	--	11.1	11.1	10.8	9.75	9.75
Bullock Fund, Ltd. (cons.)	--	--	--	--	--	8.75	8.75	7.3	7.3
Canadian Investment Fund, Ltd.	--	--	--	--	--	9.5	9.5	9.5	9.5
Century Shares Trust	--	4.0	4.0	4.0	6.25	8.5	8.5	7.5	7.5
Commonwealth Investment Co.	--	--	--	--	--	7.0	7.0	7.0	7.0
Dividend Shares, Inc.	--	--	--	--	--	9.5	9.5	9.5	9.5
Equity Fund, Inc.	--	--	--	--	--	5.0	7.0	7.0	7.0
Fidelity Fund, Inc.	--	--	--	--	7.75	7.75	7.75	7.75	7.75
Fundamental Investors, Inc.	--	--	--	--	--	--	8.5	8.5	8.5
General Capital Corp.	--	--	--	--	--	--	--	--	6.4
Group Securities, Inc.	--	--	--	--	--	--	--	9.6	9.6
Income Foundation Fund, Inc.	--	--	--	--	--	--	--	9.89	9.89
Investors Fund of America, Inc.	--	--	--	--	--	--	--	--	9.25
Maryland Fund, Inc.	--	--	--	--	--	--	--	9.5	9.5
Mutual Investment Fund	--	--	--	--	--	--	9.5	9.3	9.3
Nation-Wide Securities Co.	--	--	--	--	--	9.5	9.5	9.5	9.5
Premier Shares, Inc.	--	--	--	7.95	7.95	7.95	7.95	--	b/7.95
Quarterly Income Shares	--	--	--	--	--	--	9.5	9.5	b/9.5
Selected American Shares, Inc.	--	--	--	--	--	--	9.0	9.0	9.0
Spencer Trask Fund, Inc.	--	--	5.3	5.3	5.3	5.3	5.3	5.3	5.3
Supervised Shares, Inc.	--	--	--	--	--	9.25	9.25	9.25	9.25
United Gold Equities of Canada, Ltd.	--	--	--	--	--	--	17.65	17.65	17.65
Wellington Fund, Inc.	--	--	10.0	10.0	10.0	9.9	9.9	8.7	8.7

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a/ Compiled from the replies to the Commission's questionnaire for the individual companies.
b/ Last rate of loading charge used. No actual distribution at December 31, 1935.
c/ Fee payable to investment company and not to the sponsor or principal distributor.

Specified dollar amount -- Regardless of the asset value of the stock or its offering price, the published load would be a certain dollar figure over the price of the security.

"Since 1933 there has been a slight movement toward lower loading charges." Table 3, which lists selling commissions charged upon shares of thirty-nine open-end investment companies during the 1927-1935 period, indicates these trends.[16] The next fee or expense that the investor should study in open-end investment companies is the redemption fee.

> In some open-end investment companies redemption commissions or fees were deducted in addition to the adjustments previously related in the computation of liquidating values for the purpose of redemption.[17]
>
> At the end of 1935, seventeen of the thirty-nine open-end companies charged a fee for redemption. Six of the eight investment companies which permitted the principal distribution to receive the redemption fee were in the group sponsored by managers of investment funds and the shares of all were sold with loading charges below the average for open-end investment companies.[18]

Of the fifteen large open-end investment companies there were only three which had redemption charges

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[16] Government Report, op. cit., p. 22
[17] Ibid., p. 24
[18] Loc. Cit.

in effect as of December 31, 1935. State Street Investment Corporation permitted deduction by the principal distributors of a fee of $1 for each share repurchased. The company explained this charge as a form of insurance on the part of the management corporation which had long-term commitment on salaries, etc.

"The Spencer Trash Fund, Incorporated, redeemed its shares at" ... 99% of its net asset value, retaining the 1% liquidating fee, so that the benefit accrued to the remaining stockholders rather than to any distributor."[19]

Massachusetts Trust has had the right to make such a charge but has not done so. The original provisions of the trust agreement required this investment trust to redeem its shares at net asset value less $2 per share and after February 1, 1929, it was required at net asset value less 1%.

With respect to the use of redemption fees, H. Dudley Swim, vice-president of National Investors Corporation, stated:

> It seems only proper that the trust itself should receive any redemption fee. Furthermore, I incline to the opinion that a nominal redemption fee, say of 1%, be retained by the trust, is proper

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[19] Government Report, op. cit., p. 25

> and desirable in order to offset the expenses of the withdrawing stockholders' "round trip," which otherwise would be borne by the fund and then hence, the remaining investors.[20]

Methods of Calculating Liquidating Value
for Purposes of Redemption by Thirty-eight Open-end Management Companies[21]

I Valuation of Portfolio Securities	Number of Companies	
Prices of securities traded on an Exchange are based on		
Last sale price	35	
Closing bid price	3	38
Prices of securities not traded on an exchange are based on		
Closing bid price	28	
Average of closing bid and asked price	10	38
Valuation made on prices as of:		
Day of tender for repurchase	13	
Next day following	13	
Other	12	38
Prices are adjusted		
To nearest dollar	3	
Yes (not specified)	1	
No	34	38

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[20] Derived from supplementary material supplied the commission for National Investors Corporation.

[21] Government Report, *op. cit.*, p. 20

II	From value of fund as computed above are deducted	Yes	No
	Full lot brokerage	7	31
	Odd lot premiums	3	35
	Administrative fees	16	22
	Estimated fees of custodians or trustees	10	28
	Taxes on unrealized appreciation	25	13
	Other charges and liabilities	8	30
III	A further deduction for a redemption fee		
	Was provided in charter or indenture	20	18 (38)
	Was charged at 12/31/35	17	21 (38)
	and payable to sponsor	8	
	and payable to company	9	
IV	The results per share figure is adjusted to		
	nearest cent	17	
	next lower cent	3	
	next higher cent	2	
	nearest quarter	1	
	not adjusted	15	

One striking similarity between the open-end company and the closed-end concept is the question of distribution.

The majority of open-end management companies were sponsored by persons closely connected with the subsequent distribution of their securities, and practically all of these companies were managed by the same person. The contract between the open-end company and the distributor generally reflected this close relationship in their operation.

The primary feature of a typical contract is that it gave the distributor the right to the exclusive distribution of the investment company's securities but did not require any commitment on the distributor's part. In other words, the distributor had an agency for the distribution of the company's shares in return for a specified commission equal to the amount of the load.

An analysis of the sale of $440,000,000 of the security issues of thirty-nine open-end investment companies during the 1927-1935 period indicates that 70% were affected by the distributors as agents for these companies while only 30% were affected with the distributors as principals.[22] However, a growing tendency has existed during the past few years for the distributors to act as principals.

Harwood and Blair,[23] say that members of the industry attribute this to two factors: first, the fear that an underwriter's liability under the Securities Act of 1933 may be imposed upon the dealers when the principal distributor acts only as an agent and, second, the possible liabilities which may be imposed upon the investment companies as principals by virtue of

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[22] Government Report, Ibid., p. 31

[23] Harwood, E. C., and Blair, Investment Trusts and Funds from Investors' Point of View (Cambridge: American Institute for Economic Research, 1937), p. 81

misrepresentation which may be made by the principal distributor, as agent, in connection with the sale of the shares.

Certain aspects in connection with the distribution of open-end shares makes this field lucrative for dealers for the distribution of open-end company shares and constitutes a continuing business; the dealers' spread or commission is at least as high as on other types of securities.

The existence of the open-end investment company depends upon the sale of its shares in a highly competitive market, which it usually acquires through a large nationwide dealers' organization. Calvin Bullock had a total of about two thousand dealer outlets over the country, of which seven or eight hundred have been active at a given time.[24]

Since these dealers handled two or three competing trusts, dealer good-will was of the utmost importance.

The dependence of open-end investment companies upon numerous dealers for distribution of their shares discouraged any effort to supervision or restriction of the dealers' trading activities. The relationship between Calvin Bullock and his dealers was stated in the

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[24] Keene's Manual of Investment Trusts, 1938

prospectus of Dividend Shares, Inc., dated July 23, 1938.[25]

Mahlon Q. Taylor, president of Massachusetts Distributors, Inc., stated that some effort was made by this company to select the dealers for the sale of shares of Massachusetts Investors Trust and Supervised Shares, Inc.[26]

From the material just presented it may be concluded that open-end companies are dependent, to a certain extent, upon dealers for the good-will of the company and the sale of shares of that open-end company.

This method of distributing investment trust shares does not differ greatly from the practices of any company, industrial or otherwise, in the process of selling their shares to the investing public.

The foregoing study for the investor has covered merely the open-end management company. Now attention should be drawn to the closed-end management company, along the same line of study pursued in regard to the open-end company.

> The period from 1926 to the end of 1929 was the era of principal organization and expansion of closed-end management companies -- investment trusts that offered no continuing plan for the sale

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[25] Dividend Shares, Inc., Prospectus, July 1938
[26] Government Report, op. cit., p. 35

> or redemption of their own shares. The 1929 market collapse virtually ended the public offerings of securities of closed-end management trusts because these shares began to sell in the market at prices below asset values rather than at prices above asset values, at which many investment company issues had previously been selling.[27]

These closed-end company securities were distributed in any one or more of the following ways:

(1) Public offerings.

(2) Private offerings and sales to bankers or sponsors.

(3) Offering to stockholders.

(4) Inter-company sales and exchanges.

(5) Offerings through options.

(6) Gifts, bonuses and stock dividends.

By far the most common method of distribution employed by closed-end management companies was the public offering: " ... sales to the public generally through the means of underwriting syndicates and retail distributors." This type of distribution accounted for $2,242,000,000, or 55% of the total value of stocks and bonds sold by all closed-end trusts during the 1927-1935 period.[28]

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[27] Government Report, op. cit., p. 92

[28] Ibid., p. 93

Another method of marketing the stock issues of closed-end management trusts was through private offerings ... sales to "selected lists" of persons.

> Shares valued at approximately $176,000,000, including inter-company transactions, were distributed by this method during the 1927-1935 period, while $167,000,000 of securities were sold to sponsoring investment bankers, banks and others directly without public offering. These two forms of placing (private offerings and sales to the bankers) accounted for 8% of the total security sales of closed-end investment trusts and investment companies.[29]

The Government Report states further that "almost 25%, or over $40,000,000 of the total shares sold by private offerings was paid not with cash but with securities which went into the portfolios of the issuing trusts or companies."

In addition to the previous mentioned methods of public and private offerings $252,000,000[30] of securities were sold by closed-end companies through offerings to their own stockholders.

The small amount of stock sold in this manner was probably due to the fact that few closed-end trusts had been established long enough prior to 1929 market crash to attempt any expansion in this matter.

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[29] Government Report, loc. cit.

[30] Ibid., p. 35

Inter-company sales during the same period (1927-1935) amounted to $1,200,000.[31]

The next method of distribution used by these trusts was that of granting option warrants. Long-term option warrants -- securities evidencing the right to subscribe to or otherwise gain stock at a specified price during a certain period of time -- were used to "sweeten" the various issues and thereby aiding the distribution.

Now that a review has been given of the methods of distribution, a search into the underwriting profits and benefits will give the potential investor a clearer insight into the costs of closed-end trusts.

The fact that so many closed-end trusts were sponsored by persons or firms engaged in the investment banking business would give rise to the theory that the sponsorship was due in part to the desire for profits. Any attempt at a statistical analysis of the sponsorship of closed-end trusts is complicated by the variety of businesses conducted or controlled by the sponsors. Consequently, only general classifications of the dominant management groups by the government has been made.

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[31] Government Report, loc. cit.

As of December 31, 1929,[32] out of a total of 162 closed-end management investment trusts and investment companies, 109 were sponsored principally by houses of issue, bank affiliates, brokers and dealers. In other words, during the period of greatest expansion approximately two-thirds of these investment companies were dominated by sponsors whose principal business activities involved the distribution of securities. Such underwriters and investment bankers as Dillon Read & Company, and Bonbright and Company, have constantly engaged in the business of sponsoring closed-end investment companies.

In the underwriting of securities of an investment company sponsored by investment bankers and security dealers the sponsors could determine all policies and practices of the trust. Few closed-end company charters contained any restrictions upon their activities and powers. The charters centralized the power in the sponsors, who made up the officers, the directors, the executives and other committees.

The greatest benefit gained by the investment bankers from closed-end investment trusts was the amount and character of compensation they should receive for underwriting the issues of such companies. This

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[32] Government Report, op. cit., p. 97

compensation took many forms, such as cash, option warrants, and free stock. The House Investigation Committee[33] discovered that out of a total of 204 public offerings through the aid of bankers during 1927-1935, options were given to bankers in fifty-three cases and securities were given in three cases. This practice was particularly widespread in 1928 and 1929 when bankers received options in 53 out of 138 issues, including 31 out of 51 common stock issues.

The cash compensation based upon published load charge[34] was itself a sizeable amount. It was reported by 163 closed-end companies that they paid $116,519,000 for the marketing of their securities for a total of $2,109,000,000 so that the selling load averaged about 5.5% of the offering price and 5.8% of the net proceeds to the investment companies.

Furthermore, such loads were sometimes computed upon shares sold upon part-paid bases, the unpaid balances of which were subject to cancellation, while the possibility of pyramiding selling commissions through inter-company holdings, without adding any new money to the industry, also presented itself.

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[33] House of Representatives, H.R. 10065

[34] House Document No. 70, 76th Congress

When the cost of financing the closed-end trust securities is considered by a person interested in management trusts the first question to come to mind might well be "Is the cost to the company and subsequently to the holder, worth the investment?"

Let us consider for a moment an investment trust attempting to sell its securities without the aid of an investment banker. The securities to be sold are comparatively unknown in a market glutted with well-known securities. If this trust was to attempt to sell its shares directly to the public few sales would be effected regardless of how worthwhile the shares might be. The biggest competition the company would be forced to face would obviously be the large known companies whose shares are on the market and the fact that they are selling an unknown issue of securities.

As has been pointed out in relatively few instances, the organizers and managers of investment trusts have, themselves, met all costs incidental to organization, and to the raising of initial capital. "In one company additional stock authorized has always been offered to existing stockholders on a preferential basis, any part of the issue not taken up being underwritten and paid for at the offering price by the banking firm

which has sponsored the company. No bonus stock has been issued, no commissions have been paid, and no part of the organization expenses has been taken from the company's funds."[35] This means that the price paid by the subscribers for new issues has been put into the company without any deductions whatever. This differs rather radically from the occasional practice of fixing a certain price for an issue of stock which is turned over at this figure to a selling group which then adds its commission percentage in determining the public offering price.

Up to this point the author has really not distinguished clearly between open-end trusts and closed-end trusts with the exception of pointing out the costs of each and the hold sponsors have on the various companies. In the final analysis, what must the investor look for in either concept?

The ultimate of any open-end trust is to become a closed-end trust for, once the trust discontinues the offering of stock issues and takes away the redemption privileges, the trust becomes a closed-end company.
The advantages presented to the investor in an open-end company are many. The investor at any time has a market

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[35] Robinson, L. R., Investment Trusts, Organization and Management (New York: Ronald Press, 1929), p. 243

for his securities in that he may turn them back to the company at their liquidating value, less a redemption charge. Any holder of these trust securities may feel that a market is being maintained for his shares as the company is under obligation to redeem the holdings.

In certain cases, open-end trusts stopped selling their shares where they attained a size deemed adequate by their manager, yet the redemption provisions of those companies are still operative and, although repurchases may be made in only small amounts, eventually they will liquidate if selling is not resumed.

In regard to the closed-end company only one statement is necessary to distinguish it from an open-end company. In a closed-end trust redemption privileges do not exist.

In this chapter the author has attempted to elucidate for the potential investor the costs inherent in investment trust securities. Also shown in this chapter are the differences, however slight, between the open-end concept and the closed-end concept. The author feels that the reader should, if possible, draw his own conclusions on this section.

There is one fact that should be cited. The potential investor should not be concerned to any great

extent over the cost to the trust for issuing securities. The cost here is very necessary. As has been shown, no company, no matter how strong financially, can hope to market its wares if the company is unknown.

The investor, when reviewing a company, should note, if possible, the cost of issuing, and from this determine the cost to him per share. In some cases it would be high, and then the investor should further investigate the company.

In the next chapter will be shown some of the problems connected with the investing of investment trust funds.

CHAPTER IV

INVESTMENT PROBLEMS AND POLICIES

The preceding chapters have dealt largely with the concepts of management trusts, the importance of management, the costs to trusts of issuing securities, and the relationship between investment trusts and the sponsors of these trusts. With this study completed it is now possible to discuss the use of the acquired funds in the purchase of securities and, if possible, to arrive at certain standards resulting from the experience of American institutions.

Management trusts are built upon the theory that a well selected and diversified group of common stocks will tend to enhance in value over a number of years and, in the long run, afford a safe and more profitable investment than bonds.

> Several studies made in recent years have undertaken to analyze the comparative investment value over a period of time of common stocks, preferred stocks, and bonds.[1]
>
> The law of increasing stock values states that over a period of years the principal value of a well diversified holding of the common stocks of representative corporations,

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[1] Robinson, L. R., op. cit., p. 250

> in essential industries, tends to increase in accordance with the operation of compound interest.[2]

In the selection of securities for investment, we must consider more than the expected income yield upon the amount invested, and may quite properly weigh the probability of principal enhancement over a term of years without departing from the most conservative viewpoint.

There seems to be little doubt in the author's mind that if the investment trusts use reasonable care in purchasing securities from producers who are enjoying or have the prospect of enjoying social demand for their products, and if participations are widely enough diversified, common stocks make very desirable investments.

How fully the laws just presented will be borne out in other industrial countries is open to speculation but, as Robertson points out,

> The position of common stocks as long-term investments rests upon three chief factors -- whether commodity prices tend upward or downward and while, if they tend downward, the otherwise depressing effect can be overcome by reducing production and thereby stimulating sales more than in proportion; and whether the productive and distributive forces of the nation are in an era of basic expansion.[3]

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2. Loc. cit., p. 250
3. Ibid., p. 251

It is obvious that if these factors are favorable -- as they have been in the United States, and seem to now again have that tendency -- common stocks will prove over the next decade or so a most profitable investment.

At this point only basic theories are being discussed and no attempt is being made to forecast coming events. However, later in the thesis various phases of the world situation will be discussed in relation to the future of investment trusts.

The following important factors have been stressed by students of investment trusts.[4]

(1) There should be enough capital in the fund to allow the representation of several industries and a considerable number of different issuers in the portfolio. The possibilities of declining earnings in one industry or unsound finances of one company will then almost certainly be outweighed by uptrend developments in other industries and other companies. This is provided that previously mentioned principles are borne in mind.

(2) There should be continuous supervision for the purpose of readjusting the common stock holdings from time to time. These changes will be in

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[4] Loc. cit., p. 251

accordance with the changing prospects in different industries and different companies. Technological change should be constantly noted by supervisors of investment trusts; production variation should be watched.

(3) There should be due regard given to the proper time for purchasing common stocks, it being almost axiomatic that short-term maturities, or bonds, under certain circumstances, offer a better temporary employment of capital funds. It is for this reason that many trusts specializing in common stocks generally leave to their managers much leeway in buying obligations, or short-term maturities, or employing their funds in time deposits or call loans. Investment Managers Company, whose restrictions on investment apply primarily to the common stocks, which it normally expects to hold, place fewer limitations upon the management as to purchases of bonds or notes during such periods as it may decide it is inopportune for the acquisition of common stocks.

(4) An attempt should be made to purchase stocks at reasonable levels.

In view of the four axioms mentioned a review of these principles, using examples, might aid in classification.

An investment trust is organized with a paid-in capital of $100,000 for the purpose of investment in common stocks. The management decides to place 90% of the fund into industrials, and maintain 10% of the fund in cash. Assuming a purchase of shares in companies A, B, C, D, E, F, G, H, I, all being industrials with a favorable outlook under existing circumstances: assuming a $10,000 purchase in each company, the balance sheet would be as follows:

Statement of Assets
December 31, 19

Assets

Securities at market quotations	$90,000	
Cash in banks	10,000	
Total		$100,000

In the course of events companies A, B and C have changed their position and the initial investment of $10,000 in each company has declined 10, 5 and 8 respectively. The balance sheet at this time would be:

Statement of Assets
June 19

Securities at market quotations	$87,700	
Cash in banks	10,000	
Total		$97,700

This would show a net loss for the period of $2,300 which might not have happened if the fund had been large enough when the initial loss had been suffered to so balance the portfolio as to eliminate this loss. This is a rather weak example but helps illustrate the point. This same example might be used to show the effect of having the money of the trust invested in too few types of industrials where a loss to the one industry would mean a loss to most of the companies in that field.

If a trust's management is inactive there is a very good possibility that some of the issues contained in the portfolio will fall in value and consequently weaken the asset position of the trust.

The example cited for the first principle may very well apply here if we assume that the management was not on the alert as to the values of the securities held in the trust's portfolios.

Today the policy of forecasting trends of general business, trends of industries and particular companies within the industry is accepted as the proper technique for market transactions. Investment trusts must be constantly analyzing the securities contained in the portfolios. Companies whose securities are owned must be carefully studied for such points as:

its place in the cycle, the position of this particular company in regard to the industries cycle, its past earnings, its possible future earnings, to name a few.

An investment trust should purchase securities at times when the immediate prospects of the market and money rates allow for a wise purchase of the securities.

In other words, while it is recognized that a stock bought in 1937 at $70 may be expected to sell at $80 in two years thereafter if prices reflect the probable expansion in output and earnings; it is nevertheless maintained that the purchase may be delayed if technical market conditions extrinsic to the security in question make probable a setback in price to $60 or $50 in the meantime.

Some investment trusts hold to the theory that such a limited number of securities should be owned, and that adequate distribution of risk can be attained without leaving the confines of the United States or investing in twenty, thirty, or forty issues.

> "... their policy is to purchase solely, or primarily, common stocks in leading American industrial and public utility enterprises and to make only such changes in the composition of the

> portfolio as may be dictated by important developments or unusual investment opportunities elsewhere.[5]

This type of investment trust firmly maintains that a searching investigation should precede each purchase, the transaction being large enough to warrant a very intensive study of the situation in individual companies. Without attempting to increase income by converting profits into cash in the normal process of reinvestment these companies avoid trading and rely upon growth and development of the companies whose securities they hold.

In the main, majority of the investment trusts of this company differ from the foregoing in the policies of investments. They hold to the theory that a broad distribution of risk is a very important safety factor in investment trusts and that diversification of investments adequate for this purpose requires one or more hundred different securities representing governments, industrials, and public utilities, and generally, though not always, a portfolio containing holdings from more than one country.

These companies determine their security purchases by reference to the investment opportunities

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[5] Robinson, op. cit., p. 254

currently presenting themselves in the markets where they are prepared to buy. When bond prices in certain countries, and for certain issues, seem cheap a larger proportion of their resources will be found in senior securities. When common stock prices, in view of prospective earnings, dividends, book value, and market trends seem reasonable, some senior securities and preferred stock will be sold, the proceeds being reinvested in common stock.

There will be occasions when the company will consider it wise to withdraw from one security or group of securities to reinvest elsewhere. Now profit or loss becomes a reality. In the case where a profit has been realized a conversion makes this a cash profit; similarly, a loss in the holdings now ceases to be a book loss and becomes actual and is deducted from income.

> An investment trust company which is under active management ... must often be in position to make purchases on a falling market. Many companies have determined at what approximate average price they would consider a given security an advantageous "buy" and in order to arrive at this end, have made initial purchases on a somewhat higher level than this average, holding themselves in readiness to acquire more in event of a reaction of prices.[6]

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[6] *Ibid.*, p. 256

Where the company is concerned in many dealings of this nature, orders are occasionally on a "good 'til cancelled" basis, while sales orders on an upward scale are frequently entered.

As a result of this method of operation many companies find that it is of the utmost importance to command funds on short notice, and not to rely exclusively on temporary bank loans. Herein lies the reason why ably managed investment trusts maintain a large proportion of their holdings in readily marketable securities, and when price reactions come about, are in a strong liquid position.

To quote from a letter to its shareholders sent out on April 16, 1928, by State Street Investment Trust:

> During the period covered by this report security prices have risen rapidly and have now attained a level which in the opinion of your management is dangerously high. In order to be in a position to benefit by any decline in market prices that may occur, we are now holding somewhat over 20% of your funds in cash and call loans ...[7]

Though this analysis was made thirteen years ago it bears out the contention that at certain times it is to

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[7] State Street Investment Trust, 1928

the trust's advantage to maintain much of its holdings in cash and those securities easily converted into cash.

To cite an occasion when an investment trust felt that securities were more promising than cash a quotation is taken from the 1939 annual report of Massachusetts Investors Trust:

> Throughout the year the trustees continued to maintain a substantially full invested position in the belief that securities were potentially more attractive than cash.[8]

By inference it may be concluded that this investment trust pursues the policy of maintaining large cash reserves when in the minds of the management this is deemed the wisest course.

Barron's, of February 10, 1941, states: "Twelve of the largest funds, for example, held about three million more cash and United States securities December 31, 1940, than they had a year previously. However, all cash, bonds, and preferred holdings of the twelve funds did not amount to quite 20 per cent of total combined assets at the end of 1940. Thus

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[8] Massachusetts Investors Trust, Boston, Mass., 1939

investment trusts are still primarily common stock funds.[9]

In determining just what position the trust should take in regard to its security holdings, Robinson[10] believes that three broad criteria should be kept in mind in investment trust buying:

> (1) The securities purchased must conform to the norms of diversification which the company has set for itself.
>
> (2) The securities must meet the trust's standards of intrinsic soundness.
>
> (3) They should be obtained at figures giving current yield and/or promise of capital appreciation, the range of maximum prices set for various eligible securities being based upon an expectation of ultimate profitable turnover.

The first of these criteria assures the stockholder in an investment trust that safety of his capital will be sought in the spreading of risk. This

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[9] Barron's Weekly, Feb. 10, 1941, p. 9.
Trusts used in this analysis: Adams Express, American Investors, Incorporated Investors, Lehman Corp., Mass. Investors' Quarterly Income Shares, Selected Industries, State Street Investment Corp., Tri-State and U.S. & Foreign Securities

[10] Robinson, *op. cit.*, p. 267

first criteria may be summed up in one word; namely, diversification. The second is an attempt to guarantee the holder of trust shares a constant return regardless of the trends in business. The third attempts to secure for the holder the business profits which ordinarily result from purchase and resale. If these three axioms are adhered to the investment trust investor will have the approximate advantages of yield and safety that may well be enjoyed by the most well-informed investor who at any phase of the business cycle is reaping profits from the capital invested.

The remainder of the chapter will be devoted to further elucidation on the first of these principles.

An obvious requirement in regard to diversification would be the provision of the effect that at all times the investment trust should have a minimum of securities in the portfolio. This is not the common stipulation, however. The requirement that a minimum number of securities must be held does not in itself give assurance of distribution of risk. It would be possible for a company to have, for example, 85% of its entire holdings in one security and the other 15% scattered among 300 different investments, each held

in very small quantities. For this reason standards of diversification are generally expressed in other ways. For example, in 1929 fifteen trusts required that not more than 5% of their total assets be invested in any one company, or security, and fourteen fixed the maximum at 10%.

In some cases these restrictions apply to securities, and in other cases, to issuers. It is apparent that a provision that forbids investment of, let us say, any more than 2% of the assets in any one security is entirely different from a limitation that states that 2% must be the maximum of the resources invested in any one issuer. As a given company may issue four to six different classes of stocks and bonds it would be possible under the first limitation to place 8 to 10%, or more, in securities of one issuing company while, under the latter restriction, the maximum amount to be invested in any one company is definitely limited.

This foregoing is an illustration of what the potential investor must look for when considering several investment trusts in which investors' money could be placed.

In the quarterly report, as of September 30, 1940, Massachusetts Investors Trust lists under its security holdings the percentage of stocks held in any

division (such as automotive) and then gives percentage of this total for each individual company.[11]

Shares	Automotive (5.0%) Company	Market	% of Market
21,000	Bendix Aviation Corp.	21¾	0.6
24,000	Chrysler Corp.	78 7/8	1.8
37,000	General Motors Corp.	49¼	1.7
11,000	Libbey-Owens-Ford Corp.	43	0.5
5,500	U. S. Rubber Company	20½	0.1
3,500	U. S. Rubber Company 8% Pfd.	76	0.3
	Machinery (1.0%)		
6,800	Draper Corp.	68½	0.4
28,500	National Supply Co.	5 7/8	0.2
4,500	National Supply Co. $2 Com. Pfd.	9	---
6,500	United Shoe Machinery Corp.	60½	0.4

At a glance an investor or potential investor may note just what percentage of the total assets are invested in any particular group and may also determine what percentage is invested in any one group or groups of securities of a particular company. This aids the interested person in determining how wisely the resources of the trust are invested. After a study of the reports of the investment trust a glance at any newspaper's financial page will allow the reader to decide the value of the holdings.

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[11] Massachusetts Investors Trust, Boston, Mass., Sept. 30, 1940

Many companies further limit the type of investment by requiring wide geographical distribution of investments especially if the company goes outside of the United States.

Following is a typical restriction cited from an indenture between Second International Securities Corporation and the Central Union Trust Company of New York.

> That of the total funds of the company invested and available for investment, not more than an aggregate of 35% will at any time be invested in securities originating in any one country other than the United States. The term "originating" is hereby defined for the purposes hereof as meaning the country in which the authority, corporation or organization, issuing such securities is incorporated or otherwise organized or established, unless the Board of Directors of the company are of the opinion that because substantially all of the assets or business of a corporation or other organization are located in some other country, such securities should be considered as originating in such other country.[12]

These restrictions are similar to those adopted by other companies in the field of investment trusts.

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[12] Second International Securities Corporation of New York, Feb. 1, 1928

In the United States are to be found many companies making it their policy to invest in American common stock, but considerable leeway is generally granted to the management as to the securities to be purchased. Numerous trusts purchase bonds, short-term maturities, loans and time deposits when the management deems it advisable. Among investment trusts which aim to employ their capital primarily, or wholly, in American common stocks are as widely differing groups as Massachusetts Investment Trust, Inland Investors, Incorporated Investors, Shawmut Associates Investment Company of America, to mention a few.[13]

On the other hand, restrictions occur in certain companies which are designed to secure a balanced holding between senior and junior securities. Certain companies require at least half of the assets to consist of evidences of indebtedness and that not more than 10% of the corporation's paid-in capital shall be invested in any one bond issue, and that not more than 5% shall be invested in any one stock issue. The determination of such ratios at any time is generally left to the management whose decision must rest upon market conditions and the money market.[14]

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[13] The Investment Dealers Digest, New York City, June 30, 1940

[14] Manhattan Bond Fund pursues such a policy.

As might be expected, the larger part of American investment trust capital rests in the securities of our country. There are, however, many notable exceptions among companies constituted to operate on an international basis, which have taken advantage of purchasing opportunities throughout the world. Investments of International Equities Corporation of America have represented over thirty countries of origin.[15]

As a further example of limitation by type of security there are many American companies which specialize in given areas, industries or types of securities, and which do not aim to hold more than twenty or twenty-five issues. What this type of company surrenders in protection, consequent upon a wide distribution of risk, they endeavor to make up by a thorough understanding and detailed checking of conditions in some limited field of investment. Typical of this type of company are the following:

	Assets in Millions
Aeronautical Securities Incorporated	829.000
Air Investors Incorporated	945.000
American Electric Securities Corporation	627.000
Chain Store Investors Trust	122.000

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[15] Investment Dealers Digest, New York City

In the main the companies dealing in a specific industry tend to be of minor importance in the trust field. When the assets of special trusts are compared with the company investing in a wide general field the result bears out the contention that the specific field has a limited opportunity in attracting investors. The following chart shows the assets of three companies having wide diversifications:

	Assets in Round Numbers
Massachusetts Investors Trust	100,000,000
Incorporated Investors	30,000,000
Lehman Corporation	70,000,000

The principle of distribution of risk, while the very foundation of investment trust policy, should not be carried further than the capacity of the staff of analysists allows. Beyond a certain point the minimizing of risk involved in scattering holdings may possibly be more offset by the difficulties met in efficiently handling so complicated a portfolio. No human being working within the bounds of time and energy can possibly give attention to more than a limited number of securities although the advice of an alert board of directors, and the organization of a competent statistical and research staff may, in the case of some

investment trusts, enable the managers safely to carry a very broad diversification.

In effecting the distribution, attention should be paid to spreading the geographical risk, providing a variety of obligors, governmental and industrial, and assuming both proprietary and creditor positions by acquiring both senior (bonds, preferreds) and junior (common) securities.

There are other factors that will at times affect portfolios; namely, political upheavels in certain countries, or sections of our own country. A further factor to be considered is the tendency of certain forces that tend to make markets "bullish" or "bearish." Different phases of the business cycle will affect differently the claims to commodities represented in securities, and claims to money represented in bonds. In order to profit from these well-known tendencies it is not essential to carry on endless variety of investments, provided the various classes thus differently affected are adequately represented.

CHAPTER V

INVESTMENT PROBLEMS AND POLICIES (continued)

In the preceding chapter there were set forth the policies of American investment trusts in the distribution of risk among their holdings. We shall now consider some of the investment standards which have been adopted to facilitate purchase of sound securities.

Restrictions concerning diversification of risk are more numerous and exact than those aiming to establish conservative investment values at the time of purchase. This must be so in the scheme of things because standards regarding distribution of holdings may be readily set up whereas the weighing of investment values is a less mechanical process requiring a very intimate knowledge of many different circumstances in the case of each security considered; and incapable of reduction to a set of rules.

The most exacting rules to be found among investment trusts take the form of limitation of investment to approved lists of securities which are published and which, unless changed, definitely bind the management's discretion. Outstanding in the use of such a

list is the Massachusetts Investors Trust whose trustees are required to purchase stocks only from an approved list of securities published quarterly which cannot be changed without first notifying the stockholders. Although it is expected that common stocks will be the normal investment of this trust, it is significant that no restrictions are placed upon the purchase of bonds. In the statement for the quarter ending September 30, 1940,[1] Massachusetts Investors Trust serves notice that Westvaco Chlorine Products Corporation has been added to the "approved list." It further states that the addition of securities to the "approved list" does not necessarily mean that the trustees have decided to purchase these securities at this time. The list is simply a method of telling the stockholders the securities that the company believes are sound.

Generally speaking, the better known the sponsors of any company, and the wider the public confidence in their banking connections, the less the tendency to apply restitutions of a very exacting nature.

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1. Massachusetts Investors Trust Quarterly Statement, Sept. 30, 1940

The Investment Company Act of 1940 states in Section 13, part 3:

> No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities, deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement, or deviate from any fundamental policy recited in its registration statement pursuant to section 8 (6) (2).[2]

Few indeed are the instances in which investment trusts have confined themselves, either wholly or in part, to securities of the "legal" groups. There do not exist in the trust field the reasons justifying such statutory limitations of their investments as is commonly imposed in the United States upon savings banks, life insurance companies, and trustees, and it would be practically impossible to operate a trust profitably upon a basis of compulsory investment in "legals."

There are many occasions where trusts purchase legals of either a short or long-term maturity, either to maintain a high degree of liquidity awaiting further investment opportunities or to reap a profit during periods of declining interest rates. But at such times

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[2] Investment Company Act, 1940, H.R. 10065

it is not the trustee aspect of the securities but the ready market they command, the maturities they command, the maturities which they carry, and the type of security they represent.

Investment trusts generally place the bulk of their resources in securities listed on the leading exchanges. The advantage of ready marketability is in itself an important consideration, but it is usually the case that securities of established companies which investment trusts would in any event be inclined to buy are quoted and dealt in on the leading exchanged. Despite the safety of purchasing only securities listed on the various exchanges, it would be a short-sighted management which would limit investment to listed securities. It would altogether prevent investment in many new industries and companies, and in issues of established financial institutions, such as the majority of our American banks and insurance companies which enjoy an over-the-counter market.

> As it has long been an accepted investment trust function to ferret out investment opportunities and to give encouragement to sound new enterprises by early purchasing among their securities, certain useful and profitable functions would be curtailed by requirements that purchases be confined to listed issues.[3]

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[3] Robinson, L.R., Investment Trust Organization and Management (New York: Ronald Press, 1929), p. 287

Restrictions of investments to "legals," or authorized lists, of securities listed on one or more of the exchanges are not as satisfactory as restrictions of a less artificial nature which point toward ascertaining whether a proposed investment conforms to certain soundness. Among these less artificial requirements are the factors concerning the age of the security, the number of years over which data may be secured concerning earnings, and book values of the proposed holdings. Inland Investors, Incorporated, had in its by-laws as of 1929, the following:

> The company shall not invest in stocks of corporations unless such corporations shall have been in business for a period of at least three years and shall have paid dividends in not less than three years upon the class of stock in which it is proposed to invest (or upon any class of stock for which the stock in question may have been exchanged) ...

While it is commonly understood that an investment trust differs from a holding company in avoiding any responsibilities of management or control arising from purchase of securities, there are but a few instances of definite restrictions on investments aimed at control.

Today the Investment Company Act tends to eliminate any possibility of an investment trust becoming a

holding company. However, the section of the law placing this restriction upon trusts is a matter of interpretation. Section 13, part 4, states that no registered investment company shall, unless authorized by a vote of a majority of its outstanding voting securities, change the nature of its business so as to cease to be an investment company.[4]

Some trusts have gone so far as to place limitations upon the amount of stock that the company may hold in any one concern. A provision of this kind is found in the by-laws of Inland Investors Corporation. The provision reads:

> The company shall not invest in the stock of any corporation if thereby the company would become the owner of more than twelve and one-half per cent (12½% of the then outstanding voting stock of such corporations).

These restrictions definitely preclude any investment for purposes of control. The restrictions that companies have placed upon themselves plus the possible interpretation of the law, today limit the purpose of the trust to that phase of business previously decided upon.

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4. Investment Company Act of 1940, p. 25

In order to make effective any restrictions as to investments some companies bind themselves within a definite period of time to dispose of any security which is found to be ineligible. If this is to be carried out it means a careful periodic check of the entire investment portfolios, without which no investment requirements can be made really effective.

As investment trusts will often have occasion to make short-term use of their resources in call or time loans, time deposits, or near-dated maturities, it is advisable that standards be adopted governing this phase of investment trust financing. Today the Federal Government[5] limits loans that a company may make. This section makes it unlawful for investment companies to lend money or property to any person if (1) such loan is not authorized by the policies of the company as recited in its registration statements and reports filed with the Commission, or (2) the loan is made to a person who controls or is under common control, with the investing company. Exceptions are made to the law for the renewal of loans outstanding prior to March 15, 1940.

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[5] *Ibid.*, p. 38, Sec. 21

A combination of individual regulations by company policies and practices plus Government regulation has done much to so encompass the trusts that, today, illegal practices are few. It has been to the advantage of companies which have prepared a course of honest and intelligent practices in this field to have further Federal regulation. The investment trust field in America, as has been pointed out, is a comparatively new endeavor and therefore much "wildcatting" has gone on in the past. The companies in the field are realizing the advantage of a sane policy of regulations in all matters concerning investment trusts.

In a summary prepared by Warren Motley, condensed for the Massachusetts Investors Trust, there is set forth a statement which clearly outlines the reasons for legislation:

> The Investment Company Act of 1940, which is the result of the collaboration of the Securities and Exchange Commission, and the leaders of the investment company industry, seeks to promote honest and effective management and to prevent the recurrence of isolated instances of wrongdoing and practices contrary to the best interests of investors. These ends it undertakes to achieve by the enforcement of certain definite standards and incidentally by the delegation to the S.E.C. of limited administrative authority, without interfering with the

> exercise of business judgment by those who are charged with the duties and responsibilities of management.[6]

Regulation is a natural outgrowth of practices pursued by certain individuals, groups of individuals, or companies. To a limited extent regulation has been practiced for some time by a number of companies to their advantage in that the limited restrictions have built up in the public's mind a feeling of security concerning the company. There is no fear that the individual companies will so regulate themselves by rules and by-laws as to hamper the primary purpose of the investment trust. The fear lies in Federal and state regulation, for a law may be passed with such rigid requirements that the initiative on the part of the management investment trusts may be destroyed.

This fear need not be expressed in regard to the Investment Company Act of 1940. Massachusetts Investors Trust feels that this law is a constructive piece of legislation, embodying principles that many trusts have long pursued.[7]

A danger does exist today in regard to further regulation by the Federal Government and various state

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[6] Ibid., p. 3

[7] 65 Quarterly Report, Mass. Investors Trust, p. 4

governments. In these days of political infringement on business the trend is toward further legislative action against all business enterprise. With this in mind the danger lies ahead if the government decides to dictate further the actions of the investment trusts. The mistake in future regulation may well be an attempt to impose requirements on all trusts that are, in reality, only applicable to a few. A further hazard in unwise legislation is the possibility that the public may be encouraged to believe that organizations and managers are properly conducting the business provided they comply with the requirements and reports which are the responsibility of the trusts, under all types of trust regulation.

It is much too soon for any person to state what the effects are or might be under the Investment Company Act of 1940, but one thing is certain -- the Federal Government has given itself the power to further control the field of investment trusts.

Floyd B. Odlum, president of Atlas Corporation, says:

> Restriction and regulation of private business by the Government is justified when necessary in the public interest. But it should not be introduced except when public interest requires, and even

> then, should leave private business as free as public interest permits.[8]

Let this statement be a guide to future attempts at legislation not only in regard to the investment trust field but any phase of business that has long been called free enterprise.

Investment trust portfolios may be regarded in one of two ways; namely, its composition at any one time; and its changing composition over a period of time. At any specific time the holdings should conform to the standards previously mentioned -- diversification, representation of sound investments. The management should be constantly on the alert to maintain the standards of the trust. Many times the portfolio of a trust must of necessity be altered to meet changing conditions of the market, and other factors having a bearing on trust portfolios.

The business of the investment trust is, as the name implies, investing, and not speculation, and its main source of income is the yield on its portfolio. However, the market varies from time to time in the same place and in different places at different times,

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[8] General Statement and Recommendations on Investment Trust Legislation, July 2, 1937

and these changes should be constantly studied with a view to strengthening the investment position and increasing the return. The sales of securities whose price is a substantial gain over cost is termed "profit-making." The selling of investments netting smaller returns in order to go into the market to purchase securities having a great yield may also be termed "profit-making" with a thought to the future sale of these newly acquired issues.

As Robinson says, "From whatever angle we choose to view the turnover policies of investment trusts, it must be recognized that they are important in the management of the investment portfolio."[9]

In regard to portfolio sales and purchases, as mentioned on the previous page, an investment trust is somewhat similar to an individual or group of individuals managing an estate.

The difference between an investment trust and a managed estate is that the former continual watching guards against extreme depreciation among investments, even though its watchfulness is consistently diverted toward adjustments on a higher plane of appreciation.

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[9] Robinson, op. cit., p. 306

Provided the investment trust's holdings are essentially sound, it has less worry concerning temporary depreciation of its holdings than does the manager of an estate, for the trust generally has capital to invest to advantage in a falling market. While purchasing in a falling market a well diversified portfolio will still allow the declaration of dividends. A trust differs from a marginal purchaser in that the trust is under no necessity of providing extra funds at an unexpected turn of the market. Its capital and its business being that of investing funds, the trust faces no unforeseen demands for liquid capital and no threats of liquidation. The trust, unlike other types of business, may hold its shares for a swing of the market to the "bull" side.

Very often a trust will operate at a complete reversal to the actions of the security-buying public. In a period where the average investor is buying in anticipation of a further rise the trust may sell the shares it holds and thus make a profit; at a period when defeatism prevails, and the timid investors are leaving the market the trust may purchase the deflated securities and hold them for a rise. An investment trust is in a position to do this in view of the fact that its capital is usually large enough to "ride out" a depressed market.

The very difficulties that the average investor must meet, and often is defeated by, are many times the very situations that the investment trust may use to appreciate their holdings. In order to give application to these principles, there may now be considered the several factors which offer investment trusts its opportunities for investment profit. These factors are: nursing investments, the factors of age in securities, the factor of risk.

Nursing of investments by trusts does not imply that trusts should hold declining securities to the point where a heavy loss is inflicted. It does, however, mean that a trust should constantly be on the alert to take steps to protect its investment.

It is very often true that the public is frightened out of an issue by the falling price or "scare" statements published in the newspapers. This is due to the lack of knowledge that the public has in regard to many, if not all, companies. While the market is falling the trust may have knowledge of the soundness of the company and, with this in mind, as well as the thought of protecting its investment already in the company, it will purchase the securities in anticipation of a rise.

Between the value for new issues placed on securities by a relatively uninformed public and the value placed on this same issue by companies who are well informed there is often a considerable spread. If the issue is sound fundamentally the process of "seasoning" which results in a broader market, frequently enhances the price of the security out of proportion to any gain either in income or safety of the issue. Many investment trusts, when, after a careful analysis, they feel that a new security will, in time, enhance its value, purchase these new securities at the time of underwriting, or purchase them from underwriters at a price below the set price when, for some reason or other, the new issue was not grasped by the public.

Previous to 1914 many British investment trusts purchased new American securities on the London markets at a price far below the price the security deserved. In time, as is common knowledge, many of these securities increased in value and added rich profits to the British trusts.

This is not an argument that investment trusts should have intimate connections with issuing houses or be interested primarily in new issues. The opposite is more likely to be the case. But when an opportunity

arises and the management feels certain that this new issue will prove profitable the trust should purchase these securities and hold them for a rise.

One of the main reasons why new issues are so frequently undervalued when compared with "seasoned" securities, other things being equal, is the element of risk which tends to devaluate the security. An investment trust should be in a position to determine exactly the risk that will be involved. Included in this determination should be the economic cycle, and the general trend. This study may work both ways. It may result in purchases when market prices are low and out of proportion to any risk involved. The study also enables the management to avoid the losses involved in purchasing overvalued "legals."

Many arguments may, of course, be raised in opposition to the idea of the author that investment trusts work well in theory but in practice they are highly unworkable. In their book Security Analysis, Graham and Dodd attack the investment trust by saying:

> Most paradoxical was the early abandonment of research and analysis in guiding investment trust policies. How these financial institutions owed their very existence to the new philosophy, it was natural and perhaps only just that they should adhere closely to it. Under its

> canons investment had now become so beautifully simple that research was unnecessary and elaborate statistical data a mere incumbrance. The investment process consisted merely of finding prominent companies with a rising trend of earnings and then buying their shares regardless of price ... Investment trusts actually boasted that their portfolios consisted exclusively of the active and standard (most popular and highest priced) common stocks.[10]

The authors of this book undoubtedly have made a very good point in regard to the laxity of the investment trusts concerning methods of investments. The period which the authors are citing includes the 1928-1929 era. At this time, as is common knowledge, all caution was thrown to the winds, not only by investment trusts but by large corporations, savings banks, and commercial banks, to mention a few. The fault was not with the trusts alone. Every type of business expected an everlasting boom in securities prices and acted accordingly. It was a period where reason and logic were cast aside for the desire to make profits. Small investors who had never before dealt in securities bought shares on margin and amassed a fortune in paper profits. Industrialists placed surplus funds of

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[10] Graham & Dodd, Security Analysis (New York: McGraw-Hill, 1940), p. 356

their corporations into the market in order to increase the profits of the business. No matter where one turned during the boom period of 1928 to 1929 people were investing in the stock market. Overexpansion and other factors gave rise to a boom unknown in our previous financial history. With all this in mind it is hardly possible to take this period as a criterion of the functioning of an investment trust.

From the experience suffered in the crash of 1929 has come new regulations regarding the trusts. These regulations have been self-imposed and in 1940 imposed by the Federal Government. Another result of this "bursting bubble" has been a more cautious attitude and more carefully laid plans regarding investments.

It might be well at this point to study what the investment trusts have done in the past year concerning the securities they have bought and sold. It will also be of interest to note the rise or fall of their cash position. The defense program and the war will naturally have no small effect upon trusts whose holdings are diversified. The Massachusetts Investors Trust, in their quarterly report ending September 30, 1940, states:

> Our defense program is gradually getting under way with the placing of numerous orders for a great variety of materials. With a number of durable goods industries

> operating at capacity and with increasing employment payrolls stimulating demand for consumers' goods, it is anticipated that industrial activity will be maintained for the balance of the year. So long as the war abroad continues, and the German blockade fails to interrupt exports to England our industrial expansion will be aided by British orders placed here.[11]

From this report it may be seen that the trusts feel that their position will be enhanced by the defense program now under way.

The investment trusts have been constantly changing their portfolios to meet the changes in demand, and increased desirability of certain issues.

> During most of 1940 investment trusts were selling common stock on balance, though not by a very wide margin. Cash holdings on the average were somewhat greater at the end of the year than at the beginning, and in addition, there was a considerable increase in the amount of preferred stocks and probably a slight increase in the amount of bonds held by many trusts. Most of the bonds and preferred stocks bought during 1940, furthermore, were of the type which suggests that investment trust managements were seeking appreciation opportunities in new fields rather than more stable investments.[12]

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11. Massachusetts Investors Trust Quarterly Report, Sept. 1940
12. Barron's Weekly, Feb. 10, 1941, p. 9

TABLE III[13]

FOURTH QUARTER PORTFOLIO CHANGES OF MANAGEMENT INVESTMENT TRUSTS

Number of Trusts Buying	Shares Bought	Stocks in Which Buyers Predominated	Number of Trusts Selling	Shares Sold
7	17,800	U. S. Steel	5	4,000
7	7,500	North American	6	10,400
5	2,400	Eastern Airlines	1	200
5	2,900	American Gas & Elec.	4	3,300
4	25,900	Greyhound	0	0
4	11,000	Standard Oil, N.J.	0	0
4	4,315	Am. Cyanamid Conv. Pfd.	0	0
4	4,000	Continental Oil	3	6,000
4	3,400	Chesapeake & Ohio	4	3,080
3	18,400	Penn. R.R.	1	100
3	11,500	Bethlehem Steel	3	2,900
3	7,900	General Motors	3	2,500
3	3,900	Allied Chem. & Dye	2	1,000
3	5,000	Texas Corp.	2	900
3	4,400	National City Bank	0	0
3	4,400	Am. Rad. & Stand. Soc.	1	200
3	1,700	Dow Chemical	1	300
3	1,100	Nat'l Paper & Power Pfd.	1	500
2	20,000	Paramount Pictures	0	0

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13. Baron's Weekly, loc. cit.

This chart will help to bring out the contention of Barron's Weekly, that investment trusts were purchasing shares for an appreciation opportunity.

Every one of the companies represented on this chart will profit from the defense program. Of particular importance is United States Steel Corporation, being the largest producer of steel in this country, and having a tremendous backlog of orders for the government. This company, however, has always been a favorite of the trusts.

Pennsylvania Railroad is another company that will increase its return due to the defense program. This road has, for many years, carried approximately 10% of all freight handled by American railroads. From this it is obvious that this railroad is in a position to declare profits from the increased traffic it will carry.

Another issue worthy of mention is the Eastern Airlines Corporation. Though this company has never paid any dividends its place is such in the market that a rise in price may come at any time.

In the table just presented notice should be taken of the fact that of the nineteen companies on the chart only three (Paramount Pictures, National City Bank, and Greyhound) are somewhat removed from industries that are directly in line for defense orders.

The appreciation opportunity is, or will be, undoubtedly present for the industrials concerned with defense.

A chart has been prepared by Barron's[14] to show the companies in which the trusts were unloading their holdings. In this list the majority of the issues are connected only indirectly with the defense program.

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[14] Barron's Weekly, loc. cit.

TABLE III (continued)

STOCKS IN WHICH SELLERS PREDOMINATED

Number of Trusts Selling	Shares Sold		Number of Trusts Buying	Shares Bought
8	15,000	Chrysler	4	2,700
7	9,300	Kennecolt Corp.	4	7,300
6	13,200	Cons. Edison, N.Y.	1	2,000
6	11,300	Montgomery Ward	4	2,200
6	8,000	Phelps Dodge	0	0
5	16,200	General Electric	2	5,500
5	4,600	International Nickle	0	0
5	2,950	Alum. Co. of Amer.	0	0
5	2,600	Du Pont de Mamours	0	0
5	2,000	Bendix Aviation	2	15,700
4	5,900	J. C. Penny	0	0
4	8,500	Westinghouse Elec.	1	1,000
4	3,900	Allis Chalmers	3	2,200
4	2,600	Douglas Aircraft	0	0
4	2,300	Sears Roebuck	2	1,600
4	2,900	Southern Pacific	0	0
3	10,100	Commonwealth - Edison	3	1,128
3	7,000	Climax Moly.	2	900
3	3,900	Glenn Martin	2	1,000
3	3,900	Deere & Company	1	1,000
3	2,800	United Aircraft	0	0

Of course this is a rather general conclusion when one notes some of the companies whose securities are being sold by investment trusts. Notable among these exceptions is Chrysler Corporation. The reason here seems to be that many trusts are reducing, though not eliminating, their holdings in high-priced auto stock while other funds were being added to their portfolios. The same reason may be applied to Bendix Aviation Corporation.

The only large group of common stocks in which investment trust buying appears to have outweighed selling in 1940 is the steel group. More auto equipments are held now than a year ago, but this is due largely to a single security -- Bendix Corporation, of which several large purchases were made by two companies whose combined sales amounted of 15,700 shares. While this large purchase was completed by the two trusts, five companies had unloaded two thousand shares.

The ship-building representation in trust portfolios has increased many times: it was practically nonexistent a year ago. Here also the trusts are taking the appreciation opportunities presented by the defense program, and especially the contracts that have been awarded to the ship-building industry.

During the period from June 30 to December 30, 1940, Bath Iron Works holdings had increased 5,000 shares, which had been purchased by the Chicago Corporation. From June 30 to December 30, 1940, Newport News Shipbuilding net increase in trust portfolios was 29,226 shares. The purchases had been made by the following companies:

Name of Company	Number of Shares Purchased
Adams Express	5,600
American International	6,700
Chicago Corporation	16,800
Tri-Continental and Selected Ind.	126
Total	29,226

The cash position of a trust is often the clue to the management's belief in the future of securities. It is axiomatic that when management feels that securities in general are rather dubious as investments for profit, a shift in the portfolio is made to a cash position. Specialized Financial Research Service conducted a research into six investment trusts' cash positions, with Dow Jones averages, through 1939 and 1940. The companies studied were: Lehman Corporation, State Street Investors Trust, Loomis-Sayles, Broad Street Investment Corporation, Incorporated Investors, Massachusetts Investors Trust.[15]

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[15] Specialized Financial Research Service, Boston, Mass., 1940

June 30, 1939

3 trusts	Good cash position
3 trusts	Smaller cash position

Dow Jones averages 130

September 30, 1939

3 trusts	Show decrease in cash or increased holdings in securities
3 trusts	Increasing cash position

Dow Jones averages 4 major in quarter

High	155.92	Quarter closed with market again about half way to another high side
Low	131.33	

December 30, 1939

3 trusts	Starting to increase cash position
3 trusts	Still getting into a better cash position

Dow Jones averages 2 major moves in quarter

High	155.48	Quarter closed with market again about half way bewteen moves -- on upward side
Low	145.69	

March 31, 1940

6 trusts	Decidedly heavy increase in cash positions by most of the six trusts

Dow Jones averages 2 moves in quarter but in narrower range

High	152.80
Low	144.65

June 10, 1940 Dow Jones Average -- Made a low of 110.41 almost three months after the trusts had shown decided increase in cash position or a lessening of security holdings.

June 30,1940 2 trusts still showed increase in cash position but in a smaller percentage than previous quarter.
4 trusts evidently had taken advantage of good cash position to pick up securities at the low prices of June

High	124.42
low	119.73

During the second quarter shown on the chart the changes in portfolio holdings depict uncertainties and varying opinions. This was due, in part at least, to the immense problems that faced people with money to invest; the corporation, the investment trust, or the individual investor. Never before has the investor faced the problems that he is forced to face today: can England defeat Germany; will the Government close the stock exchange in case of war; will the totalitarian powers continue to disrupt the economic scheme of things; will foreign selling of American securities be resumed and where will the pressure show itself; war or peace in the United States?

In the past year investment trust managers have had the fact of the threat to invade England, the certainty of a large defense program, the knowledge that taxes in 1941 will be over two billion greater than in 1940, that there is existing in Europe a food shortage.

Since 1940 there has been a wide divergence in investment trust opinion concerning the market. We find that Adams Express reported cash and equivalent, as of March 1939, as 14% of its total assets, but three months later this was down to 7.05% (September 30, 1940, 7%). As of December 30, 1940, this item was up to 10.3%. General American had only 5.7% of its fund in liquid

form at the end of the first quarter of 1939, but by June 30, had increased its holdings of cash and equivalent to 19.4% of total assets (as of September 30, 1940, 14.9%). As of December 30, 1940, 13.2% of its total assets were in the form of cash or its equivalent. Massachusetts Investors Trust had a slight increase in cash and equivalent, as did Lehman, but State Street and Chicago reported small decreases in cash and equivalent.[16]

It is apparent that the managers of many trusts were greatly perplexed during the last months of 1940. Caution seems to be the important factor to these managers; therefore, the most obvious development was in increase in cash. While the average increase was only 1.1% six investment trusts showed marked increases in their cash position. The shift in holdings was to preferreds in many portfolios. Jackson and Curtis, in their study, say: "... there was a 100% increase in this classification of holdings over the last quarter of 1940, while the increase in bonds was not as pronounced."[17]

The trends of investment trusts have been a striving to improve the quality of their stocks while at the same time to increase their cash position to a moderate degree. This increased cash position seems to

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[16] Figures for 1940 taken from a study made by Jackson and Curtis, Boston, Mass., Feb. 24, 1941

[17] Loc. cit.

indicate that the managers are either uncertain as to the future of the security market or they are anticipating a further drop in what is now a very sluggish market.

The future of the American investment trusts depends upon a number of factors. The majority of the trusts known today have never weathered a war. What effect a prolonged war would have on these financial institutions is unknown. If the Government, in time of conflict, should close the exchanges of the country it would mean a freezing of the assets of the trusts.

A further question has entered the field. Many trusts have become known as "orphan trusts" or trusts in which, each year, the size of the trust shrinks; each year the cost of management rises to a greater percentage; each year the shareholder who invested with a reasonable hope that healthy management would continue to declare profits sees the prospect of a fair return on his money growing smaller.

Investment trusts such as these are "orphan" trusts. They have no sponsorship, or a sponsorship which confines its activity to a "do nothing" attitude.

This orphan situation arose under the Investment Company Act of 1940. These companies have been called upon to register under this act if they hope to continue to redeem their certificates.

Investment trust men such as C. Shelby Carter, president of the First New England Corporation, have analyzed the industry and have discovered a large number of these "orphans." Mr. Carter feels that public opinion and pressure might be brought to bear on these companies to clean up the picture. If the public would bother to concern itself about the orphans of the industry there would be no problem, for no sensible man would leave his money in an institution wherein percentage paid for management costs showed no inclination to do anything but rise.[18]

A consolidation of these outcast trusts may be a solution to the problem. If this were planned many problems would arise in regard to portfolios, management, sponsorship, rules and regulations concerning diversification, trustees, to mention a few. To concern oneself with these problems would call for a separate study rather on a tangent to this research.

However, these problems are not unique. It must be borne constantly in mind that this industry is still in its youth and still has the "growing pains" of adolescence.

This chapter has continued the discussion of investment practices and policies, citing instances where

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[18] N. Y. Times, March 2, 1941, Financial Section

companies have limited their activities to certain classes of opportunities, as in the case of the Inland Investors, which has limited itself to corporations which have been in business for at least three years.

The investment trusts have limited the scope of their activities by statements made in the rules of incorporation, or in statements of policy, and by so doing have defined for the investment public the intention of the management.

Various phases and types of regulation have been discussed. The types range from voluntary regulation of the weakest type, which merely defines the activities of the company, to the Investment Company Act, which rather rigidly restricts and controls the functions of the company.

CHAPTER VI

CONCLUSION

The investment trust, being an infant industry, has much to be desired in regard to management, cost to the investor for purchase and resale of some classes of securities, and the investment theory and practice that the industry, as a whole pursues. With these weaknesses in mind, just what justification may be found, then, for the existence of these trusts?

Scientific investment is a very difficult, if not an impossible undertaking, but true business profits may be obtained if the market operations are properly handled by competent persons in charge. The investment trust in the hands of effective management secures an adequate return on the money invested.

> The general theory of business profits is applicable to investments; and further investment of funds is a real business, subject to the rewards of true business foresight, and the losses incident to attempts on the part of the poor business manager to invest funds. The school teacher, clergyman, shoe manufacturer, know enough about their own respective business to feel assured that the ordinary uninitiated could not succeed without long and specialized training. Yet these men stand ready to embark on one of the most intricate

> businesses -- that of investment -- requiring perhaps the most extensive and far-reaching specialized knowledge of any profession or business.[1]

To the layman interested in investing some capital in the securities market, the technical details mean little or nothing to this type of person. A technical knowledge in investment is not his.

The investment trust, with its efficient technically trained personnel, is in a position to help the layman investor by offering to him the benefit of the experience of the men composing the trust.

Investment trusts bring investment opportunity within the reach of all classes of people, including those individuals who, because of various reasons, cannot efficiently invest their funds directly. Investment, especially that which involves a considerable degree of speculative risk is a business within itself. Investment trusts offer to these people an opportunity to have a part in the financial transactions of the country.

These trusts tend to reduce risks incident to investment at a distance or in holdings the merits of which are not known. By placing funds with a trust the risk is lessened, due to the fact that these companies

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[1] Speaker, Lawrence W., The Investment Trust (New York: A. W. Shaw Co., 1924), p. 59

have at their disposal a greater amount of information and technical skill which is required in the field of securities.

The trusts of the country also aid in the financing of domestic enterprises. The policy of many trusts is to nurse new industries until the company is on its way to financial and industrial success.

The trusts do not attempt this financing as a matter of common practice, but when the opportunity presents itself and the trusts are reasonably certain that the investment is sound, money will be invested in the enterprise.

In this way these companies serve a very useful function in our economic system.

Investment trusts do not attempt to combine ordinary commercial banking with the investment trust business. A large amount of obligations tied up in demand loans in time of financial strain will prove a source of weakness. It is, therefore, good policy to invest a considerable portion of the trust's funds in securities that are readily marketable. This marketability is a very important consideration for upon it depends the soundness of the assets of the company. An investment trust with its assets so held that they are not readily convertible will find itself in difficulties

if the occasion should arise when the trust needed its funds.

Investments must have a certain amount of diversification; i.e., security holdings so spread among a number of industries as to assure safety in the portfolio of the company. This diversification does not mean, however, a large percentage of the assets in one or two securities and the remainder spread over a large number of companies. If this type of diversification were used the safety factor would not be present.

Trusts attempt to place their securities under a variety of plans, depending upon the individual company. Diversification may be accomplished by geographical distribution, industry distribution, or distribution in one particular type of security; i.e., bonds, preferreds, or common stock of any issuer.

The potential investor must look to three main items when considering an investment trust as an opportunity for investment, which are:

(1) management;

(2) investment policies and practices;

(3) dividend record.

Management has been studied in this research, primarily from the standpoint of compensation in direct

proportion to training and successful operation of the trust. In this field, as in any other, to secure trained management adequate compensation must be an inducement. But the plan should be of a nature to continually encourage the management to increased success of the business. Five plans have been advanced as a method of managerial compensation. It is not possible to say that one of the plans is better than the other four. Each method of compensation has its advantages and each plan has a very definite use in the various types of investment trusts.

As the name -- management trust -- implies, the most important phase of this type of business is the character and capability of management. Unless those in control are honest, and at the same time have an adequate knowledge of world finance, including the details of investment trust administration, the results in most cases will be failures.

Management in this field, as in any other business enterprise, must have the things at its command and that will make it possible for the company to weather all types of business difficulties. The men in charge must be dynamic, rather than static, types in order that the company will progress at a tempo with the times. Those in charge must not be afraid to make a decision if

they feel that the judgment they have made is to serve as the best solution to any problem which they have faced.

Along these same lines another problem has come to mind in preparation of this research. It would be of value to study the managers of representative trusts throughout the country in an attempt to determine their background, their connections with the field of finance and the profits they have earned for their respective companies.

The investment policies and practices of any particular company might be considered, in importance, next, only, to the aspect of management, for upon this phase of the business rests the possibility of success or failure on the part of the company to declare dividends. Along these lines this study has attempted to present many of the phases, including diversification, restrictions, criteria of investment, legals, listed securities and the seasoned character of issues. All these aspects of security purchasing must be considered by management when securities are purchased. At no time may any of the above-mentioned items be discarded, for the soundness of the investment policy rests upon them.

Costs are always of some importance regardless of the type of business. In the investment trust field the costs incident to marketing the company's shares are termed "loading charges." These charges have varied with the individual companies, depending upon the amount of compensation received by the distributors for their task of marketing the shares. This charge is usually stated as a fixed percentage of the net asset value per share and represents the known premium over the basic price which the investor pays to become a stock holder or participant in an open-end trust. The important fact to be noted in regard to loading charges it, however, the hidden charges which the distribution of open-end securities allows. These hidden charges are not found in the distribution of closed-end securities.

All open-end companies are alike in that a calculation of offering and redemption prices start with the net asset value per share which is in turn based upon the market value of the portfolio holdings.

Redemption fees are found only in open-end trusts, as a holder of a closed-end trust certificate has no right to redeem his holding for cash at the company's expense. Here, as in the case of the sale of shares, the fee goes to the principal distributor. There has been, however, a tendency, in the past few years, to

do away with this fee. The argument used to uphold these redemption fees was that the company used this charge as a form of insurance against its long-term commitments which included salaries, wages, etc.

Some companies have used the fee as protection to the remaining stockholders. Other open-end trusts have the privilege to place a charge on redemption but have not done so.

The question of fees charged to the investors has long been a source of argument, but the investor should not be too concerned with the cost unless it appears that not enough of his invested dollar is reaching the portfolio of the open-end trust.

Public offering has been the principal method of distribution employed by the closed-end trusts as is evidenced by the value of shares so distributed ($176,000,000) during the 1927-1935 period, as compared with the value of shares ($167,000,000) sold to sponsoring firms during this same period. Public offering then has proved the most successful of the six methods[2] used by closed-end trusts.

Closed-end trusts, in the main, have been sponsored by houses of issue; i.e., investment bankers,

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[2] See p. 41

brokers and dealers. Many persons are of the opinion that the sponsorship was simply due to the desire for profits. This might very well be true, but an advantage presents itself in that the trusts now had capable backing and technical knowledge to aid in the issuing of the trust's securities and purchasing of high-grade issues for the portfolios.

The sponsors naturally derived profit from the venture, but isn't this true of all business undertakings? For the knowledge and experience loaned to the trust some compensation was necessary to the sponsors.

Investment banking has been a very valuable aid in the floating of security issues. A new company will run into difficulties while attempting to market unknown issues, but a sponsor with a well-established organization and a good name will have a very minimum of difficulty in selling to the public a new issue. The established name is similar to a guarantee.

Legislation last year has done much to protect the holders of trust issues. What the final result will be is at this time impossible to determine. It may be noted that, unqualifiedly, every witness representing the industry endorsed the bill.

This bill is therefore a highly salutary indication that Government and business may cooperate in

the proper spirit to do a constructive job. Representatives of the business felt that the bill, when passed, would protect the industry from nefarious practices by certain individuals or groups of individuals who would use the industry to swindle investors. Representatives further urged the passage of the bill due to the present international situation.

The representatives of the industry felt that proper and reasonable regulation of investment trusts would stimulate the companies to supply new capital for the expansion of industry, particularly industries vital to our national defense. To speed up this activity the bill authorizes investment companies to contribute a portion of their capital to companies organized by themselves to underwrite the securities of, and to furnish capital to, industry.

The necessity for the regulation arose, then, from certain practices carried on by individuals, or groups, within the industry. Heavy losses have been suffered by investors due to these nefarious practices. These mal-practices cannot entirely be eliminated by the individual companies, many of whom have placed rigid regulations in their by-laws; they must be stopped by Federal regulation. This conclusion was conceded by

virtually every witness who appeared before the subcommittee of the House of Representatives.

The Securities Act of 1933 and the Security Exchange Act of 1934 have not acted as deterrents to the continuous occurrence of abuse in the organization and operation of trusts. These acts provide, primarily, for publicity. Publicity is not enough to remove the mal-practice from the field. Further, the great majority of investment companies have never come within the jurisdiction of these acts.

The Act, then, is necessary to protect the small investor from the breaches of trust upon the part of certain managements, and provide such persons with the protection that comes from a regulated industry. This legislation will also prevent those abuses that have damaged the industry, as a whole.

The committee hearings brought forth another problem; namely, taxes. This problem has already been recognized as existing in the case of certain open-end trusts. No attempt has been made in this study to present the problem of taxes. This field is a study in itself, and could not be incorporated in any other study and still do justice to one field or the other.

An attempt has been made in the previous chapter to show what the trusts have been doing in regard to

their portfolio holdings within the past two years. The significance of this study is an attempt to determine a trend within the industry. The increase in cash holdings would indicate that the trusts are carrying out a program of cautious purchases and sales. The Lease Lend Bill may have been a reason for the increased cash position. Until this bill was passed there was a certain feeling of uncertainty as to what course of action the Government would pursue.

A further proof of the cautious policies being pursued by the trusts is the increase by almost 100% of preferred stocks. The trusts, in purchasing preferreds, seem to be seeking a guaranteed income of a certain percentage rather than a higher rate of return plus an increase in speculation. All this caution seems to be borne out in the market of late. The exchange has experienced some very slow days at which time common stocks fell off one to three points. By placing funds in preferreds the trusts are certain of percentages on their invested capital.

Investment trusts, in purchasing common, have, in the main, concerned themselves with those industries essential to our national defense -- such stocks as United States Steel, Continental Oil, Dow Chemical, Bethlehem Steel, Pennsylvania Railroad -- to mention a few. This

is an obvious attempt to convert the rush of defense to industry into profits for the companies.

Weighing these purchases of common stocks against the increased cash holdings and purchases of preferreds, what are the conclusions to be? Obviously, the trust managements are uncertain as to the plan of action. They are too fearful of future events to invest heavily in the common stock securities of the day, yet they apparently show a desire to increase such holdings as evidenced by the purchases of securities issued by companies vitally concerned with defense. The question will probably be answered within a relatively short space of time. America has now committed herself to a very definite policy of all-out aid to Britain. For the first time in months investment trusts, as well as others interested in finance, have something very definite on which to base their investment theories. Managers of trusts must now plan their policies and so arrange their portfolios as to receive the maximum advantage from the national program of defense.

In doing this research many questions beyond the scope of this study have entered the author's mind. One such question concerns the payment of dividends by investment trusts. No mention has been made of dividends though they are of importance to the investor. The

Investment Company Act devotes one whole section (19) to this question.

This thesis, when originally planned, was to deal exclusively with the open-end concept of trusts; but study in the field subsequently brought forth the fact that a study of this subject would require nothing but original research. As this was impossible at this time the study of one concept of investment work had to be given up. This problem, however, still remains in the author's mind, for so few people have ever heard the term, let alone know the actual workings of such a trust. It is desired to some day make such a study.

Investment trusts have fallen into somewhat of a decline in the past few years and because of this most of the newer material that was read as background material had to be cast aside as only one viewpoint was presented.

It is the author's contention that investment trusts play a major role in our economic life and, if properly regulated, may climb to new heights as a sound form of investment for one of limited means. Only time will be able to bear out this contention, in view of the regulation now imposed by the Government, plus the regulations that trusts have placed upon themselves as a result of the losses in the years following 1929.

Experience is the best teacher, and if this proves to be true for investment trusts, it is more than a probability that they will climb to a better place in the financial world.

As institutions such as insurance companies, banks, loan associations, all serve a definite function in our financial sphere, so do investment trusts for the reasons that have been shown in this chapter. Some people would have others believe that the investment trust field is overrun with mal-practices, as is no other field. This is an absolute untruth. Every industry, in passing through its early years, has had this same difficulty. The railroads of the past century, while serving a very definite function, were hotbeds of swindlers. It was the same with the oil industry. It may be found in the history of most utilities.

The investment trust, as we know it today, is approximately seventeen years of age. In this short time it has not emerged from its period of so-called errors. But in a few years, when maturity has been reached, a test should then be made and a very definite conclusion drawn as to the real need for investment trusts.

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APPENDIX

GENERAL AMERICAN COMPANY, INC.

(Office: 120 Broadway, New York City)

Incorporated October, 1928. In September, 1929, it was absorbed by merger, General American Investors Company, Inc.; holders of 800,000 shares of common stock (no par) of old General American Investors, receiving in exchange therefor no par value common stock of corporation, on a share for share basis, and corporation assuming the $7,500,000 5%, 25 year debentures, Series A, due February 1, 1952. Business of the company is to acquire, hold, sell and underwrite securities of any nature, both foreign and domestic.

Classification of Portfolio, Section 24
(in thousands)

	1939		1938	
	Amount	% of Total	Amount	% of Total
Bonds:				
Industrial	233	0.82	230	0.74
Railroad	515	1.81	388	1.25
Public Utilities	152	0.53	429	1.38
Total	900	3.16	1047	3.37
Total Preferred Stock	2408	8.46	1273	4.10

	1939		1938	
	Amount	% of Total	Amount	% of Total
Common Stocks:				
Industrial	19750	69.35	25060	77.58
Railroad	1138	3.99	916	2.96
Public Utilities	3087	10.84	2116	6.83
Financial	1196	4.20	1600	5.16
Total Common Stock	25171	88.38	28692	92.58
Total	28479	100.	31012	100.

Capital Stock

	Authorized	Outstanding Dec. 31,1939
6 Preferred (no par)	94,000*	72,000
Common (no par)	3,500,000	1,300,220

*28,000 shares have been retired but 6,000 shares have been eliminated from authorized capital.

ADAMS EXPRESS COMPANY

A voluntary association formed in July 1854, under common laws of New York State; was formerly engaged in express business. Express business was consolidated in American Railway Express, which company took over the express rights; Adams Express took over stock of American Railway Express.

Classification of Assets
(in thousands)

	1939		1938	
Stocks:	Amount	% of Total	Amount	% of Total
Oils	3937	13.16	4368	13.12
Bld. & Real Estate	2083	7.15	3185	9.56
Mining	3663	12.57	4160	12.49
Investment	1814	6.23	2127	6.39
Iron and Steel	2361	8.11	2797	8.40
Electric Equipment	1418	4.87	1330	4.00
Office Equipment	1281	4.40	1844	5.54
Agricultural Equipment	1089	3.74	999	3.00
Amusements	629	2.16	972	2.92
Aviation	1263	4.34	1142	3.43
Chemicals	1455	4.99	653	1.96
Railroads	149	0.51	239	.72
R. R. Equipment	241	0.83	388	1.16
Rubber			309	4.93
Merchandise	553	1.90	1490	4.47
Shipping	552	1.89	357	1.07
Distiller			17	0.5
Automotors	772	2.66	1321	3.97
Fertilizer	75	0.26	184	.55
Advertising	213	0.73	188	.54
Public Utilities	38	0.13	613	1.84
Sugar	237	0.81	----	----
Miscellaneous	----	----	69	.21

	1939		1938	
	Amount	% of Total	Amount	% of Total
Bonds	1130	3.88	1619	4.86
Total Investment	24996	85.82	30363	91.18
Cash	4072	13.98	2688	8.07
Acc. Int. & Div.	40	0.14	58	.18
Amt. Rec. for Ser. Sold	3	0.01	178	.54
Property and Equip. (Book Value)	14	0.05	12	.03
Total Assets	29126	100.	33299	100.

INCORPORATED INVESTORS

Incorporated November 23, 1925, in Massachusetts, as a mutual investment trust. The funds of the trust are invested under the guidance of the Board of Directors upon whose discretion Articles of Incorporation place no distinction. Policy of the company is to place not more than 5% of the fund in one security. In no sense is this a fixed trust; supervision is constant and changes are made when necessary. Securities owned by the trust are held by the Old Colony Trust Company.

Management. All statistical, clerical and administrative services are supplied by the management for a fixed fee of ½ of one per cent a year of the principal; deduction does not include taxes, brokerage fees and transfer charges which are paid by the company.

Diversification of Portfolio

	1939	1938
Cash and Government Service	9.6	5.3
Metals and Mining	11.3	14.3
Chemicals	8.8	9.8
Railroads	8.1	9.9
Building	4.9	6.6
Oils	9.6	9.1
Electric Equipment	7.4	7.5
Steel	4.9	5.7
Aviation	3.3	2.9
Merchandise	4.9	5.1
Miscellaneous	13.1	13.4
Banks and Finance	5.1	4.4
Automobile	5.7	4.6
Public Utilities	3.3	1.4

THE LEHMAN CORPORATION

Incorporated September 11, 1929, in Delaware, as investment trust of the general management type. There are no restrictions on the purchase or sale of securities.

Classification of Assets (in thousands)

	1939		1938	
Bonds:	Amount	% of Total	Amount	% of Total
Cash & Receivables	2767	4.0	1563	2.2
U. S. Gov. Sec.	4639	6.8	6302	8.8
Total	7407	10.8	7865	11.0
Other Bonds:				
Public Utilities	668	1.0	1477	2.1
Railroads	511	0.7	606	0.8
Merchandise	2275	3.3	2278	3.2
Total	3455	5.0	4361	6.1
Preferred Stocks:				
Public Utilities	2836	4.1	2145	3.0
Railroads	61	0.1	123	0.2
Merchandise	239	0.4	1245	1.7
Total	3136	4.6	3513	4.9
Common Stocks:				
Agricultural Mach.	1774	2.6	2023	2.8
Auto and Rubber	4645	6.8	3759	5.2
Aviation	2250	3.3	2067	2.9
Bank. & Finance	1880	2.7	1993	2.8
Building and Construction	1548	2.3	3542	4.9

Common Stocks (continued):

	Amount	% of Total	Amount	% of Total
Cans and Contain.	1718	2.5	1063	1.5
Chemicals	6370	9.3	4444	6.3
Foods and Beverages	2470	3.6	1955	2.8
Machinery and Equipment	3033	4.4	3446	4.8
Manufacturing, etc.	2244	3.3	2175	3.0
Merchandise	4791	7.0	5654	7.9
Metals & Mining	3761	5.6	6194	8.6
Oils	6869	10.0	8363	11.7
Public Utilities	4790	7.0	4186	5.8
Railroads	2027	3.0	1956	2.7
Railroad Equipment	1611	2.3	1634	2.3
Steel	2384	3.5	240	0.3
Tobacco	155	0.2	668	0.9
Total	54421	79.3	55364	77.2
Invest. Real Est. Corporation	100	0.15	412	0.6
Other Real Estate Investments	100	0.15	150	0.2
Gross Assets	68618	100.	71666	100.
Less Liabilities	510		698	
Less Allowance for Federal & State Income Taxes	----		255	
Net Assets	68108		70713	

SPENCER TRASK FUND, INC.

Incorporated in March, 1929, in Delaware, to invest and deal in stocks and securities of all kinds, to participate in syndicates and underwritings, and to exercise other powers granted by certification of corporations.

Classification of Net Assets
(in thousands)

	Market Value			
	1939		1938	
	Amount	% of Total	Amount	% of Total
Automobile	278	8.4	271	5.6
Aviation	91	2.7	---	---
Building & Material	---	---	464	9.6
Chemicals	571	17.1	555	11.5
Communication	222	6.6	269	5.6
Electrical Equip.	116	3.5	508	10.6
Merchandising	498	14.9	561	11.7
Mining & Smelting	240	7.2	378	---
Misc. Manufacturing	169	5.0	---	---
Oil	65	1.9	---	---
Public Utility	221	6.6	---	---
Railroad	166	4.9	---	---
Railroad Equipment	---	---	---	---
Steel	71	2.1		
Cash & Other Assets	574	17.2		

STATE STREET INVESTMENT CORPORATION

Incorporated in July, 1924, in Massachusetts, to provide a medium for the examination and selection of common stocks; to own the best ones during favorable periods and to take a partial cash or cash equivalent position during unfavorable periods. In 1932 it acquired the assets of Pittsburgh Bond and Share Corporation. As of October, 1933, it purchased the assets of Investors Security Company of Massachusetts, and in December, 1933, acquired the stock of Mohawk Investment.

Management. State Street Research and Management Company (a partnership) pays all expenses of management, research, bookkeeping, etc., in consideration of a quarterly fee equal to 1/8 of one per cent for the market value of the net assets of the corporation, plus one dollar per share charged for shares repurchased by the corporation (to redemption charge).

Earnings Data -- December 31, 1939

1939	2.97
1938	1.66
1937	4.17
1936	3.81
1935	1.52
1934	1.15
1933	0.68
1932	1.60

T A B L E I

How Investment Trust Assets Are Diversified
Combined Holdings of Twelve Companies*

(000's omitted)

Industry	Dec. 31, 1940	No. Comp. Holdings	Dec. 31, 1939	No. Comp. Holdings	% Charge 1940	% Charge Barron's Group Average 1940
Total Assets	443,987	12	508,350	12	-12.7	---
Cash & Equiv.	40,681	12	32,800	12	+7.6	---
Oil Prod. Mfg.	40,271	12	52,170	12	-22.8	-15.9
Metals & Min.	34,187	12	44,425	12	-23.0	-3.8
Chemicals	32,493	12	37,935	12	-14.3	-12.9
Utilities Com.	30,950	11	41,855	12	-26.1	-22.0
Merchandising	29,841	12	39,980	12	-25.4	-11.2
Utilities Pfd.	20,739	10	18,680	10	+11.0	-6.7x
Steel	19,334.	11	18,480	11	+4.7	-0.4
Building	17,593	12	22,260	12	-21.0	-21.9
Railroads	17,051	11	19,060	11	-10.5	-13.3
Autos & Trucks	16,995	11	22,260	11	-22.9	-16.4
Elec. Equip.	14,135	11	16,820	12	-16.0	-9.9
Farm Equip.	11,998	12	17,100	12	-29.8	-19.8
Bank & Finan.	11,306	9	12,590	9	-10.2	-22.7
Aircraft	10,012	11	10,650	11	-6.0	-11.5
Pfd. Stock other than Utilities	9,274	11	5,811	11	+59.6	**
Bonds other than Rail.	8,048	8	8,984	8	-10.4	**

*Based on portfolios of Adams Express, American International, Blue Ridge, General American Investors, Incorporated Investors, Lehman Corporation, Massachusetts Investors Trust, Quarterly Income Shares, Selected Industries, State Street Investment Corporation, Tri-Continental and U. S. Foreign Securities.

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Management Investment Trusts

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